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SOCIAL SECURITY REFORM: IS MORE MONEY THE ANSWER?

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SOCIAL SECURITY REFORM: IS MORE MONEY THE ANSWER?

MONDAY, MARCH 1, 1999

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 1:05 p.m., in room SD–628, Dirksen Senate Office Building, Hon. Charles Grassley, (Chairman of the Committee) presiding.

Present: Senators Grassley, Hagel, Collins, Hutchinson, Bunning, Breaux, Bryan, Bayh, and Lincoln.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY, CHAIRMAN

The CHAIRMAN. I would like to call the meeting to order. I am Senator Chuck Grassley, Chairman of the Aging Committee. I am happy to welcome for the first time Senator Hutchinson from Arkansas, who is a new Member of the Committee, and appreciate his involvement.

We generally do not start without a member of the minority party being with us, but I have been told that it is OK with Senator Breaux, our ranking Democrat, if I proceed and he might be about 10 minutes late getting here. If we start with our preliminary statements and things of that nature, it will save time and still accommodate Senator Breaux.

I thank all of you for joining us this afternoon. We all want to remember that this is Senator Breaux's birthday. I want to acknowledge another year for an outstanding political leader from Louisiana and a national leader in the Democrat Party.

I also want to thank Deputy Secretary Summers and say how pleased we are for his participation in this hearing because he is a person, if you follow the newspapers, who probably does as much traveling and is on top of all the important issues for the administration as any cabinet or sub-cabinet member can be. We know you are very busy and we thank you for taking time for this very important issue that I know you are one of the lead Administration people on this issue.

Today our committee will address two important issues, President Clinton's Social Security proposal and other revenue options to save the program. I hope this hearing will put reform back on track. Last year's public discussions seemed to get us going in the right direction.

When President Clinton spoke to a group of college students at the University of Illinois in January 1998, he said Social Security

reform should not be about imposing intolerable burdens on our children. He asked questions along the lines of, what is the fairest way to change this? What is best for baby boomers? What is best for high school kids who have not even started in the system?

Those are questions that needed to be raised in January 1998 and they are still very legitimate questions today. As you have heard me say so many times, I thank the President for making Social Security less of a politically sensitive issue by raising these questions and having 1998 as being a period of time to discuss and to reflect on what the options are.

With all due respect and thankfulness to the President for raising these issues and reducing the political sensitivity, I somehow today do not believe that the President's budget proposals remotely begin to answer the questions that were put to the University of Illinois students.

I have acknowledged that paying down the debt is a valid goal. The President has that in his program. I think we do in our majority program as well. So this is not a point of disagreement.

What we need to be debating is whether general revenue financing should have a role in the Social Security program. Financing an entitlement program for the elderly with general revenues is not new. As an example of what can come when you rely too much upon general revenues would you please take a look at two charts we have over here?

The first shows Medicare income for 1998. As you can see, Medicare receives about $60 billion in general revenue right now. The next chart shows that only about 54 percent of Medicare's income came from the payroll tax. The rest is financed by general revenue, out-of-pocket costs for seniors, and premiums.

We need to decide if it is wise to bet the farm on a huge budget surplus as a way of avoiding making some tough choices. The President has avoided tough choices. I do not mean that his solution is painless. First, this new budget assumes that the discretionary part of the budget will be 25 percent cheaper in years to come. Is that realistic?

I am sure that future Congresses, will want to provide services for constituents from medical research to child care improvements. Budget projections, I think, should reflect that.

Second, we have all had experiences with budget projections that somehow do not come true. Suppose we go along with the President's plan and the surpluses do not materialize? Interest costs will not decline to historically low levels. But we will still have to transfer billions of dollars to the trust fund.

There is no heavy lifting involved in that sort of plan. The real contest is in how to make changes in Social Security that will actually extend its life.

So we still have not solved the financial problems and we have not solved the demographic problems. Under the President's proposal, we still need to find ways to close the actuarial imbalance for another 20 years. That brings us to the second issue of today's hearing, other revenue options.

So far, most policymakers have said we need to stay away from increasing payroll tax rates. Other options are still on the table. We want to assess the advantages and disadvantages of the propos-

als that seek to add more revenue into the mix to keep pace with benefit growth.

We have to keep in mind that there are other elderly programs facing funding shortages. Some of the same sources of revenue are on the table on the health side as well. Hopefully we will learn more about the support or the lack of support for these options.

I want to once again thank Lawrence Summers for being here with us. I want to also thank Dr. Rudolph Penner of The Urban Institute. He has done a lot of work thinking about Social Security recently, which I am sure will be very helpful to the committee.

We are going to also hear from Edith Rasell of the Economic Policy Institute, and Wendell Primus of the Center for Budget and Policy Priorities. They represent organizations which have conducted some thought-provoking research and analysis on various Social Security reform issues. And finally, we will hear from Martha Phillips of The Concord Coalition.

Ms. Phillips and her organization have played a pivotal role in the Social Security debate, moving it forward as well as, I think, doing a very good job of keeping political leaders honest as they talk about these issues.

While we await Senator Breaux to speak for the minority, I will call according to arrival. Senator Hutchinson and then Senator Hagel and then Senator Lincoln. Welcome, Senator Lincoln, because you are attending your first meeting of the committee as a new member. Thank you very much.

Senator Lincoln. Thank you, Mr. Chairman.

The Chairman. I am going to back off of calling on Senator Hutchinson. I have announced that you have a birthday today. Happy Birthday and you can speak right now.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR CHARLES GRASSLEY

I would like to call this hearing to order. Thank you all for joining us this afternoon. Before I get into the subject of today's hearing, I want to say Happy Birthday to my colleague, Senator Breaux.

I would also like to thank Deputy Secretary Summers for participating in the hearing. We are pleased to have you here.

Today the Committee will address two important issues: President Clinton's Social Security proposals and other revenue options to save the program. I hope this hearing will put reform back on track. Last year's public discussion seemed to get us going in the right direction. When President Clinton spoke to a group of college students at the University of Illinois in January 1998, he said Social Security reform should not be about imposing intolerable burdens on our children.

He asked some questions: What is the fairest way to change this? What is best for the baby boomers? What is best for high school kids who haven't even started in the system yet? I agree that those are the questions that need to be raised. I do not believe that the President's budget proposal remotely begins to answer them.

I have acknowledged that paying down debt is a valid goal. That is not the point of disagreement. What we need to be debating is whether general revenue financing should have a role in the Social Security program? Financing an entitlement program for the elderly with general revenues is not new. We have two charts—the first shows Medicare income for 1997. As you can see, Medicare receives about 60 billion dollars in general revenues right now. The next chart shows that only about 54 percent of that income came from the payroll tax. The rest is financed by general revenues, out of pocket costs for seniors, and premiums.

We need to decide if it is wise to bet the farm on huge budget surpluses as a way to avoid making tough choices. By saying that the President has avoided tough choices I do not mean that his solution is painless. First, this new budget assumes that the discretionary part of the budget will be 25 percent cheaper in years to come. Is that realistic? I am sure future Congresses will want government to pro-

vide a variety of services to their constituents, from medical research to child care improvements. Budget projections should reflect that. Second, we have all had experience with budget projections that somehow don't come true. Suppose we go along with the President's plan and the surpluses don't materialize. Interest costs will not decline to historically low levels. We will still have to transfer billions of dollars to the trust fund.

And we still haven't solved the financial problems and we have solved the demographic problems. Under the President's proposal, we still need to find ways to close the actuarial imbalance for another twenty years. That brings us to the second issue for today's hearing: other revenue options that would solve the problem. So far, most policy makers have said we need to stay away from increasing payroll tax rates.

Other options are still on the table. We want to assess the advantages and disadvantages of proposals that seek to add more revenue into the mix to keep pace with benefit growth. We have to keep in mind that there are other elderly programs facing funding shortages. Some of the same sources of revenue are on the table on the health side as well. Hopefully, we will learn more about the support, or lack of support, for these options from all of our witnesses.

The first witness will be Lawrence Summers, a person who plays a very important role in formulating the Administration's policies on Social Security, revenues, and the budget.

We will then hear from a second panel representing a variety of viewpoints. The panel includes Dr. Rudolph Penner of the Urban Institute. He has done a lot of thinking about Social Security recently which I am sure will be very helpful to the Committee.

We also will hear from Edith Rasell of the Economic Policy Institute and Wendell Primus of the Center on Budget and Policy Priorities. They represent organizations which have conducted some thought-provoking research and analysis on various Social Security reform issues. And finally, we will hear from Martha Phillips of the Concord Coalition. Ms. Phillips and her organization have played a pivotal role in moving the Social Security debate forward as well as keeping us all honest.

We welcome all our witnesses.

Senator BREAUX. Well, thank you very much.

The CHAIRMAN. I just finished my opening statement.

Senator BREAUX. This committee is now becoming more and more important every day with each and every birthday passing by.

STATEMENT OF SENATOR JOHN BREAUX

Senator BREAUX. Thank you very much, Mr. Chairman, and thank our distinguished witnesses we are going to be having today. The subject matter is a very powerful subject matter that we are dealing with because when you are talking about what do we do with Social Security, we are talking about a program that affects not just the 44 million Americans who are on it, but everybody because everybody either is on the program or knows someone in their family who is on the program or eventually will be on the program themselves.

So the real question, when we have something that affects every single American is, how do we make sure that the qualities of the program are going to be there for future generations.

There are no easy answers. All of these entitlement programs that we are facing, it is very, very difficult choices and it is not any mystery as to why we have the problems we have. No. 1, people live longer, thank goodness, and thank medical science for it.

No. 2, is that there are a lot more of them who live a lot longer. From 16 working people for every one person on the program, we are down to about three and it is getting lower than that. So the problem is very obvious. The reason for the problem is very obvious. The solutions are not.

There are no easy political solutions to a program of this nature. Over the years, Mr. Chairman, we have fought political battles over something that really should not be a political battle as much as just an equity battle.

We have blamed Republicans for trying to decimate the program and you have blamed Democrats who are trying to make it a political football and as a result, nothing gets done because no one party can solve this problem by ourselves. It is going to take Republicans and Democrats working together or it is not going to happen. We have tried it the other way and it never happened.

So the final point I would make is the question about saving Social Security, which the President has made as a very important priority, which I agree with. I will always add when he says that, add Medicare as well because the programs are very similar in who they cover and what we are trying to accomplish for society.

He has suggested that we should use the surplus for the Social Security program. We should not be misguided into thinking that the surplus will save Social Security. I mean, we can save the surplus for Social Security, but the surplus will not save Social Security. We have to do more than that.

Putting more money into the existing program without reforming the current program is only part of the solution and does not solve the problem. So what we are going to hear today hopefully are some good ideas about what should be done and how we go about doing it.

Thank you for having this and once again, I think this sort of non-legislative committee is taking the legislative lead and I thank you for that.

The CHAIRMAN. Senator Hutchinson.

STATEMENT OF SENATOR TIM HUTCHINSON

Senator HUTCHINSON. Thank you, Mr. Chairman, and I also want to express my appreciation for you calling the hearing today on the financing options for Social Security. It is a critically important subject and a very timely hearing and I want to thank Secretary Summers for joining us as well.

The Social Security program, as Senator Breaux said, is at a crossroads. The decisions we make as Members of Congress, we make now in order to preserve the long-term financial stability of Social Security, are going to affect not only our generation of baby boomers, but generations to come.

I agree with Senator Breaux that if it is going to happen, if there is going to be reform, it is going to happen on a bipartisan basis. It is going to have to be Republicans and Democrats working together and it is going to have to be with a determination not to play politics with this issue.

The dates 2014 and 2030 are becoming ingrained in everybody's mind as to when it goes in the red and as to when, without change, it would face bankruptcy. I just would hope that we do not end up, as we did with Medicare, coming to the last 2 or 3 years before the crisis is so critical that it is then thoroughly in the mix of politics; that now is the time to act and now is the time to act beyond political consideration.

None of the decisions are going to be easy. In Arkansas alone, Mr. Secretary, there are 320,000 Arkansans who are Social Security beneficiaries, who are over the age of 65. Approximately two-thirds of those beneficiaries are women.

As illustrated in the hearing held by this committee just a week ago, for most women beneficiaries, Social Security benefits are what keeps them above the poverty line. So any change in cost of living adjustments or cuts in benefits are going to have a very serious impact on seniors in Arkansas.

Mr. Chairman, it is significant, I think, we have two Arkansans on this committee, but Arkansas has the second—of those above the age of 65, we are second in the Nation in the percentage of those who are above the age of 65 with 20 percent of our citizens being 65 and older, behind only the State of Florida with 21 percent.

But if you look at it in terms of poverty, senior citizens living in poverty, Arkansas is at the top. So these issues have particular pertinence to my constituents.

Social Security is known as a universal program, one which has provided security for generations of retirees. If we take the path of means testing and increasing the taxable wage amount, or if we further tax benefits of high-income beneficiaries, we will take one more step away from a universal program toward a needs-based program.

If we decide to fund the program with general revenues, we must ask ourselves, are we breaking the direct correlation between contributions and benefits and will this be a one-time fix or will we begin a trend of simply adding more money to the program without making any fundamental reforms?

I think that is the key, is for us to make those fundamental systemic reforms that will preserve this system for generations to come. There are serious issues that warrant our consideration today and I look forward to the testimony. Once again, Mr. Chairman, I appreciate you calling the hearing.

The CHAIRMAN. Thank you. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I, too, add my welcome to our witnesses and I have a statement that I will submit for the record. Thank you, Mr. Chairman.

[The prepared statement of Senator Hagel follows:]

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Good afternoon, Mr. Chairman. Thank you for calling this timely and important hearing.

The debate over what to do with Social Security is one of the most vital that our Nation faces. There is no one in America, or in this room, that will not be touched by this debate. The decisions Americans make today on this issue will profoundly affect our future.

This is a spectacular opportunity. Not since Social Security was created have we had a chance to look at it and ask some very basic questions. What do we want this program to do for us and at what cost? What should the role of government be in providing retirement security?

This discussion is not about short-term fixes. It's about finding long-term solutions. We all want the same thing—to keep our Social Security strong and secure.

The Congressional Budget Office (CBO) has estimated that over the next 10 years, the Federal budget will generate a unified surplus of over $2.5 trillion. However,

$1.8 trillion of the surplus is tied to the Social Security trust fund, leaving a $787 billion surplus from other on-budget transactions. We must be honest about these figures. These surpluses are not real. They are on paper only and may change over the years. We need to be careful with the estimated budget surplus as we proceed since a good portion of it is tied to the Social Security trust fund.

Will the extra money accumulating in the Social Security trust fund save Social Security? No. If we do not strengthen and restructure the Social Security system, by 2032 it will be unable to pay the same retirement benefits being paid out to our seniors today. That sounds like a long way off, but it's only 33 years.

So what do we do? If we sit around and wait for this to become a crisis, we'll have two options—raise taxes or cut benefits. We could take more out of the paychecks of hard-working Americans or pay less in benefits to those who rely on Social Security. Both are unacceptable.

The benefits of a new system must be clearly defined for the public. If the American people don't believe a restructured Social Security system will be better for them and for their children, they won't support making changes.

I would like to see a personal retirement account component in any Social Security reform package. Personal accounts would harness the power of private markets and compound interest, giving individuals ownership of their retirement savings. Americans want more power, more choice, more responsibility in deciding their own future and economic well-being. It's their money!

However, those people currently in the system must have their benefits guaranteed. I'm not talking about making changes for those currently on or soon to come on Social Security, I'm talking about changes for the future. We can create a system that still provides a safety net for those most vulnerable in our society, but offers younger workers the opportunity to save for the future and create wealth for their retirement years.

I look forward to hearing from Secretary Summers and the other panelists on their thoughts about the future of Social Security.

The CHAIRMAN. Thank you, Senator Hagel. Senator Lincoln.

STATEMENT OF SENATOR BLANCHE L. LINCOLN

Senator LINCOLN. Thank you, Mr. Chairman. I certainly appreciate your leadership in this committee and on this issue and I, too, have a statement, full statement I would like to submit for the record.

The CHAIRMAN. Without objection, so ordered.

Senator LINCOLN. Thank you, sir. I would like to thank the Chairman and Senator Breaux, and wish my colleague a happy birthday. One consolation is, you hit Social Security before 2032, I do not.

I wanted to apologize to the Chairman, also, for missing last week's hearing on women and Social Security. It is a very, very critical and important issue to me personally as well as in the State of Arkansas, as mentioned by my colleague.

My colleague and I had some business at home in Arkansas and it was unfortunate that we missed that hearing. However, I do believe that Senator Breaux conveyed my interest in the subject last week and I plan to be very active in addressing this issue.

The issue of Social Security is one of great importance to Arkansans. As my colleague mentioned, over half a million of the persons in Arkansas rely on Social Security. We are second only to Florida in the percentage of our population that are elderly.

Medicare is also a very important issue to our elderly because of those who are on Medicare, approximately 40 percent have their premiums paid by Medicaid. So it is important that we look at the care and the quality of life of the elderly in our State of Arkansas.

We know that those currently receiving Social Security benefits will continue to enjoy the benefits our Government has promised in the agreement that was made. However, it is the younger gen-

erations, the baby boomers and the Generation Xer's who need to get involved in this great debate.

It is very important to those of us who have been contributing to Social Security that we look for a reasonable answer to the very grave question that we face that will benefit not only the elderly of today, but certainly those of us that will be using this program in the future.

We must look at this program, which began in 1935, and adapt it to meet our changing demographics for the new millennium. It is a historic moment in our nation's history because we are finally running a surplus and can devote much of this surplus to shoring up the Social Security system.

I spoke much about that during the recent campaign and I am dedicated to making sure that we see that that happens. While both political parties may agree on the concept of using the majority of the surplus to save Social Security, they both know that even the surplus is not enough, just as my colleague, Mr. Breaux, stated to keep Social Security on a sound footing.

There are tough choices that will have to be made. There are no easy answers to the questions that we have before us and we must all work together across all age boundaries and across any political boundaries as well.

I am sure that there will be lively debate over the changes that must be made to keep the system solvent and I dedicate myself to being an active part of that. Of course, I will be paying particular attention, as my colleague, Senator Hutchinson mentioned on how all of these proposals will affect women.

As the only female Democratic member of the committee, I am especially concerned that any changes to the Social Security system protect women because they do live longer and they tend to earn less over their lifetime than men do.

I am eager to hear from our distinguished panel of witnesses here today about the many proposals that are being discussed, what some of their solutions and thoughts are on how we can make this incredibly important program in our nation solvent for many years to come.

I thank the Chairman for his leadership and I look forward to today's hearing and certainly the work we have before us.

[The prepared statement of Senator Lincoln along with Senator Craig follows:]

PREPARED STATEMENT OF SENATOR BLANCHE LINCOLN

Thank you Chairman Grassley and Senator Breaux. The issue of Social Security is one of the most important issues facing Arkansans. Over half a million persons in Arkansas rely on Social Security. And as I promised constituents during my recent campaign for the Senate, I plan to play an active role in the debate on how to effectively reform this critical program.

Today, we can be comforted in knowing that those currently receiving Social Security benefits will continue to enjoy the benefits our government promised. However, it is the younger generations, the Baby Boomers and Generation Xers who need to get involved in this great debate. We must look at this program which began in 1935 and adapt it to meet our changing demographics in the new millennium so that the system will continue to provide financial security to all older Americans for generations to come.

This is an historic moment in our nation's history. We are finally running a surplus and can devote much of this surplus to shoring up Social Security. While politicians in both parties may agree on the concept of using the majority of the surplus

to save Social Security, you can be assured that there will be "lively debate" over what changes must be made to keep the system solvent.

Tough choices will have to be made. Of course, I will be paying particular attention to how all of these proposals affect women. As the only female Democratic member of the Committee, I am especially concerned that any changes to the Social Security system protect women because they live longer and tend to earn less over their lifetime than men do.

I'm eager to hear from our witnesses about the many proposals that have been floating around. I want to thank them in advance for coming here today and stimulating the great debate on Social Security.

PREPARED STATEMENT OF SENATOR LARRY CRAIG

I would like to thank the Chairman for holding this hearing today regarding the President's Social Security proposals. I would also like to thank each of the witnesses for taking the time to appear before the committee to testify.

We have a unique, once in a generation opportunity to safeguard and improve the retirement security of our seniors and the economic security of today's workers and our children. The Social Security surpluses projected for the next few years should be used to save and modernize the system. The benefits of today's seniors can and will be completely protected. Today's younger workers can and should be given some degree of ownership of their retirement accounts. Workers should have the option of real investments with significantly better rates of return than the current system of Federal IOU's. We can modernize Social Security and make sure we have a strong safety net for the less fortunate. There are a lot of innovative ideas out there. My priority is to look at the best, constructive, creative, new ideas and build a strong, financially sound for the future.

Again, I would like to thank the Chairman and our panel of witnesses here today. As the Social Security reform debate continues to intensify, it is crucial that we thoroughly discuss effective options for strengthening the system. Though we may not agree on the solutions, your testimony here today is a step in the right direction. Thank you.

The CHAIRMAN. Now to our witnesses. Every witness can have their full statement printed in the record and summarize according to the procedure of this committee. Then also, would each witness also realize that even for members who are here, some questions might be submitted for answer in writing? We would like to have a response to those by 2 weeks from now, if that is possible.

We now go to Lawrence Summers. He is the Deputy Secretary of the U.S. Treasury and he is a former professor of economics at Harvard University. I thank you for joining us and please proceed.

STATEMENT OF LAWRENCE SUMMERS, DEPUTY SECRETARY, U.S. DEPARTMENT OF TREASURY, WASHINGTON, DC

Mr. SUMMERS. Mr. Chairman, I hope you will not hold that last credential against me.

Thank you very much, Mr. Chairman, for providing me with this opportunity to testify on these very important subjects and I very much appreciated the opening statement to the members of the committee, and in my initial comments will try to take up some of the issues that were raised.

Mr. Chairman, we live in a moment of great national opportunity with $4.5 trillion in surpluses projected over the next 15 years. But we also live in a moment of great national challenge with our population rapidly aging and the fiscal burden of our Social Security and Medicare programs projected to increase substantially over the next decades.

It is the essence of the President's approach to try to take advantage of the opportunity to meet the challenge. The President's framework, as you know, devotes 62 percent of these surpluses to the Social Security system. Of the roughly $2.8 trillion in surpluses that will go to Social Security, four-fifths will be used to purchase Treasury securities and one-fifth will vest in private sector equities.

These two actions would push the trust fund's exhaustion date back to 2055 and solve approximately two-thirds of the projected problem.

The President has also suggested that in the context of Social Security reforms, we follow the lead of a number of members of the committee and emphasize the importance of strengthening the benefits that are provided to women in general and widows in particular, and also that we eliminate the earnings test which is distortionary and discourages retirement at a time when we want to see people working longer.

The President also proposes an allocation of the surplus to Medicare and to make pension coverage universal through universal savings accounts. The President's approach has three crucial benefits.

First, it would greatly strengthen the financial position of the Federal Government. If we follow the President's approach, we will eliminate the national debt sometime between 2010 and 2020.

That means that the 13 percent of the Federal budget that now goes for interest will no longer go for interest and that will free up in the budget an amount that exceeds the extra share of GNP that we are going to have to be allocating to Social Security as a consequence of our aging society.

Second, by allocating these surpluses or a substantial portion of the surpluses to Social Security and Medicare, it could lengthen these trust funds to 2055 in the case of Social Security and 2020 in the case of Medicare.

And third, by substantially increasing national savings, it would meet our crucial national priority ahead of our aging population. Much of our prosperity in recent years is due to the fact that a trillion dollars that otherwise would have had to be invested in the sterile asset of government debt has instead been available for new

investment for American workers and new homes for American families.

His budget continues that process by assuring that the national debt will essentially be eliminated, causing some $3.5 trillion that otherwise would have gone into government paper to be available to reduce foreign borrowing and our current account deficit, and to provide for increased plant and equipment and increased housing investment.

The President's proposal proposes to further provide for the challenge of an aging society through universal savings accounts to spur private savings and make pension coverage essentially universal.

Mr. Chairman, in your letter of invitation, you raised the question of additional revenues for Social Security. To be clear, the administration's view is in light of the tremendous opportunity provided by the budget surplus, the best way in the near term to get revenues into the Social Security trust fund to meet future obligations is to rely on those surpluses.

I might add, Mr. Chairman, that as a number of members of the committee stressed in their opening statements, we share the view that while use of the surpluses can make an enormous contribution to Social Security, it is not in and of itself sufficient to put the program on the sound footing that it should be.

That is why the President has called for a bipartisan process to identify the additional measures, the additional structural changes in Social Security that on top of using the surpluses and investing in equities can provide for 75-year actuarial balance rather than the actuarial balance over the next 55 years that can be achieved just with the surpluses and reliance on equities.

This approach inevitably has raised a number of questions and a number of them were reflected in your own opening statement, Mr. Chairman, and that of other members of the committee. Let me just, if I could, comment on three of those questions.

First, the question is raised whether the President's proposal, by placing bonds in the trust funds, makes real provision for the future of Social Security and Medicare. This is obviously a critical issue given the challenges that face those programs.

Certainly it does. It creates the fiscal capacity necessary to meet increased obligations to Social Security and Medicare by eliminating interest payments that would otherwise be an obligation of the Federal budget in the out years when we have an aging society.

Second, it creates the legal capacity to assure that those savings, in fact, go to Social Security and Medicare beneficiaries by assigning the proceeds of the debt reduction to the Social Security and Medicare programs.

A second crucial question raised by this proposal is what happens if all these projections turn out to be wrong and the budget surpluses materialize in a less favorable way than is now projected. I cannot resist pointing out, on behalf of my colleagues in the administration who do these economic forecasts, that they have proven to be too pessimistic for 7 years in a row.

Nor can I resist pointing out that for the first time in many, many years, the administration's budget forecasts over the next 10

years are actually less optimistic than those of the Congressional Budget Office.

But certainly, none of us would be responsible if we did not recognize that there are large uncertainties in these forecasts. That is why an approach like the one pursued by the President that assures that the surpluses will not be dissipated on new spending programs or new tax cuts is the appropriate one.

Even if a much more pessimistic projection were to obtain, we would continue, under the President's proposal, to be reducing the national debt and the interest burden that it imposes.

Third, Mr. Chairman, the question arises, what about investments in equities, and this, of course, has been a controversial subject. I would only say to you that almost every other defined benefit pension plan in America gives its beneficiaries the extra return that is afforded by providing for investment in equities.

In order to offset the benefit that the President's proposal gains with its modest investments in equities, it would be necessary to impose a 5 percent across-the-board benefit cut beginning in 2030, or alternatively, to raise the retirement age by an extra year-and-a-half.

We are convinced that through a combination of private sector management, an independent board, reliance on index funds, it is possible to manage equity investments in a publicly responsible way and that we owe it to America's Social Security beneficiaries to give them the benefits that diversified investing can achieve.

Mr. Chairman, in conclusion——

The CHAIRMAN. Well——

Mr. SUMMERS [continuing]. We have a tremendous opportunity and let's use it to meet this challenge.

[The prepared statement of Lawrence Summers follows:]

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TREASURY DEPUTY SECRETARY LAWRENCE H. SUMMERS
SENATE SPECIAL AGING COMMITTEE

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear today to discuss President Clinton's proposal to ensure the financial security of our aged population. The demographic challenge that we as a nation face today is a critical issue to all Americans and to the future of our economy. As you know, it is in direct response to this challenge that President Clinton has offered his framework for preserving the financial well-being of the Social Security and Medicare programs and improving the retirement security of all Americans. Let me applaud this Committee for its contribution in addressing and focusing attention on these issues.

The advent of an era of surpluses rather than deficits has radically transformed our national debate about entitlements. The terms of all of the earlier tradeoffs in the entitlements debate have been eased -- provided we seize the opportunities now available to us. The President's framework for Social Security both recognizes the brighter present reality, and moves us well along the road toward seizing the opportunities currently available, if we can work together on a bipartisan basis.

This afternoon, I will first briefly describe the President's program. Then, I will devote the bulk of my remarks to addressing some of the issues that have arisen about our approach to retirement security policy.

The President's Proposal

According to the Office of Management and Budget, the unified budget of the federal government is now projected to accumulate more than $4.5 trillion in surpluses over the next 15 years. The operational question now before us is how we should use these surpluses.

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The President's framework devotes 62 percent of these surpluses to the Social Security system. Of the roughly $2.8 trillion in surpluses that will go to Social Security, about four-fifths will be used to purchase Treasury securities, the same securities that the Social Security system has invested in since its inception. The remaining one-fifth will be invested in an index of private-sector equities, which should on average yield a higher rate of return for the program's investments. These two actions will reduce the 75-year actuarial gap from its current level of 2.19 percent of payroll by about two-thirds, to 0.76 percent of payroll. And they push the date at which the Social Security trust fund is projected to be exhausted from 2032 back to 2055.

Substantial as that accomplishment would be, it is critical that we do more. Historically, the traditional standard for long-term solvency of the Social Security system has been the 75-year actuarial balance. A 75-year horizon makes sense because it is long enough to ensure that virtually everyone currently participating in the system can expect to receive full payment of current-law benefits. Attaining this objective will require additional tough choices. But the objective is both important and obtainable. To reach it, the President has called for a bipartisan process. We believe that the best way to achieve this type of common objective is to work together, eliminating the need for either side to "go first."

In the context of that process, we should also find room to eliminate the earnings test, which is widely misunderstood, difficult to administer, and perceived by many older citizens as providing a significant disincentive to work. In addition, it is critical that we not lose sight of the important role that Social Security plays as an insurance program for widows and children, and for the disabled. As President Clinton said last month: "We also have to plan for a future in which we recognize our shared responsibility to care for one another and to give each other the chance to do well, or as well as possible when accidents occur, when diseases develop, and when the unforeseen occurs." That is why the President has proposed that the eventual bipartisan agreement for saving Social Security should also take steps to reduce poverty among elderly women, particularly widows, who are more than one and one-half times as likely as all other retirement age beneficiaries to fall below the poverty line.

In addition to shoring up Social Security, the President's plan would transfer an additional 15 percent of the surpluses to Medicare, extending the life of that Trust Fund to 2020. A bipartisan process will also be required to consider structural reforms in this program. This process will be informed by the important work of Chairman Breaux and the other members of the Medicare Commission, and we look forward to their report.

Finally, the President would use 12 percent of the surpluses to create retirement savings accounts — Universal Savings Accounts or USA accounts — and the remaining 11 percent for defense, education, and other critical investments. The President will be announcing further details regarding the USAs soon.

Benefits of the President's Approach

In essence, the President is proposing that we use the Social Security and Medicare trust funds to lock away about three-quarters of the surpluses for debt reduction and equity purchase, and ensure that they are not used for other purposes. This would have three key effects:

- First, it would greatly strengthen the financial position of the government. If we follow this plan, by 2014, we will have the lowest debt-to-GDP ratio since 1917 and will free up a tremendous amount of fiscal capacity. The reduction in publicly held debt will reduce net interest outlays from about 13 cents per dollar of outlays in FY99 to about 2 cents per dollar of outlays in 2014. Under the President's program, the reduction in interest due to debt reduction will exceed the increase in the Social Security burden through the middle of the next century.

- Second, it would strengthen significantly the financial condition of the Social Security and Medicare Trust Funds. Indeed, it would extend the life of the Social Security Trust fund by more than 20 years, to 2055, and extend the life of the Medicare Hospital Insurance Trust Fund to 2020. Meeting our obligation to the next generation of seniors should be the number one priority in allocating the surpluses.

- And third, it would substantially increase national saving, which must be a priority in advance of the coming demographic shift. By paying down debt held by the public and investing in equities, the President's program will create $3.5 trillion more room in private portfolios for productive capital in place of the sterile asset of government paper. In effect, this will be the reverse of the "crowding out" that occurred during the era of big deficits. With government taking a smaller share of total credit in the economy, interest rates will be lower than otherwise would be the case. The implications of lower interest rates will be profound. Not only will individuals be able to borrow for mortgages, school loans, and other purposes at lower rates, but importantly, businesses will be able to finance investments in productive plant and equipment at the lower rates. And the resulting larger private capital stock is the key to increasing productivity, incomes, and standards of living. Ultimately, one reason why this program is sound economically is that it will result in a more robust private economy, which will expand our capacity to make good on our Social Security and Medicare promises.

The President's proposal also specifically aims to deal more broadly with the challenges of an aging society by expanding individual access to retirement saving. As I noted earlier, the President proposes to devote 12 percent of the surpluses to establishing a new system of Universal Savings Accounts. These accounts would provide a tax credit to millions of American workers to help them save for their retirement. A majority of workers would receive an automatic contribution structured as a flat dollar amount regardless of income. In addition, many of those who make voluntary contributions would receive a matching contribution from the government to their USA account. Overall, the program would be considerably more

progressive than the current tax subsidies for retirement savings -- where higher bracket taxpayers get higher subsidies.

At the same time, the President proposes to strengthen employer-sponsored retirement plans in a variety of ways. The President's budget addresses the low rate of pension coverage among the 40 million Americans who work for employers with fewer than 100 employees by proposing a tax credit for start-up administrative and educational costs of establishing a retirement plan and proposing a new simplified defined benefit-type plan for small businesses. Workers who change jobs would benefit from the budget proposals to improve vesting and to facilitate portability of pensions. In addition, the retirement security of surviving spouses would be enhanced by the President's proposal to give pension participants the right to elect a form of annuity that provides a larger continuing benefit to a surviving spouse and to improve the disclosure of spousal rights under the pension law.

Additional revenues

Mr. Chairman, in your letter of invitation, you asked that I address the merits of various possible ways of bringing additional revenues into the system. A wide variety of such options have been included in the plans that have been put forward in the last few months. As you know, the President has expressed his belief and determination that we should be able to put Social Security on a sound long-term financial foundation without increasing the payroll tax rate. The payroll tax hits all workers and it hits the low and middle of the earning scale proportionately harder than more affluent individuals. Partly because of this, the President believes that other ways of closing the gap are preferable.

With regard to most other ways of increasing the revenues of the system, the Administration has striven to maintain an open mind. We have emphasized that individual proposals should not be judged in isolation, but rather in the context of complete plans. And the President strongly believes, as I noted before, that the way to achieve final agreement is for both parties to work together, avoiding in the meantime actions that would polarize the debate. For that very reason, it would be counterproductive for me to discuss specific alternatives -- regardless of their merits or demerits. The time for us to exchange such views will come, but, in my judgement, is not here today.

Investing in Equities

As I noted above, an important element of the President's framework is the proposal to invest part of the transferred surpluses in equities. Historically, the Trust Fund has been invested exclusively in government bonds. While these bonds are essentially risk-free, they have the corresponding downside that they have historically earned a lower rate of return, on average, than other potential investments. Between 1959 and 1996, the average annual rate of return earned on stocks was 3.84 percent higher than the rate earned on bonds held by the Trust Fund.

Raising the rate of return on the Trust Fund would substantially alleviate the need to bring additional revenues into the system. Even in the President's program, in which the proposed equity investment is modest, the impact on the actuarial balance is significant: It would reduce the actuarial gap by an estimated 0.45 percent of taxable payroll -- roughly one-fifth of the overall problem we face today. Put another way, the proposed investment in equities achieves as much, in terms of improving the 75-year actuarial balance as a 5 percent across-the-board cut in benefits beginning in 2030. Or, to put it still another way, the equity investment in the President's package achieves as much for the financial soundness of the system as would moving the normal retirement age up by an extra year-and-a-half. Given the magnitude of what the equity investment will accomplish, I believe that the President's proposal should receive serious consideration as a means of, in effect, bringing new resources into the system.

Addressing Issues

Since the President unveiled his plan in the State of the Union Address, a number of important issues have been raised. Let me briefly address a few of them here.

Is the President's framework based on sound accounting?

One issue is whether the President's framework is based on sound accounting methods. In this regard, the framework is grounded in two essential ideas:

- First, the framework should speak to the disposition of the whole of the *unified* surplus, which encompasses both the Social Security and non-Social Security portions of the budget. As I outlined earlier, the President proposes to reserve the bulk of the unified surplus for the purpose of paying down the debt held by the public and for acquisition of assets. Some have criticized the framework for proposing a disposition of the whole of the unified surplus, but in doing so the framework follows squarely in the tradition of Republican and Democratic administrations alike for each of the past 30 years. Moreover, any time a competing proposal is cast in terms of how it would use the unified surplus, the validity of our fundamental approach is reinforced.

- Second, the framework should ensure, to the greatest extent possible, that the surpluses that have been transferred to the Social Security and Medicare Trust Funds may not be used for any purpose other than to pay down the debt held by the public or to acquire assets. In short, these transfers must constitute a *full use* of those resources. It is clear to us that current budgetary methods are inadequate in this regard because they would not sufficiently wall off the transferred amounts and protect them from being used either to finance additional spending or tax reductions. We are looking forward to working with the members of this Committee and the rest of the Congress to devise new methods for achieving this fundamentally important objective.

Debate about accounting arcana threatens to obscure one crucial point: that -- as Secretary Rubin stated in his budget testimony -- at the core of this budget is fiscal discipline. We must not lose sight of the fact that this budget is possibly most notable for the fact that it lays the groundwork for paying off the debt held by the public. That is the most prudent budget accounting of all.

Can equity investment in the Trust Fund be undertaken in a sound, prudent manner?

Another issue concerns the potential for political interference in the investment of a portion of the transferred surpluses in equities. We take this issue seriously. Accordingly, we have devoted a good deal of effort to developing an institutional framework aimed at isolating these investment decisions from political pressures. With this framework -- or one like it -- we are confident that the concerns that have been expressed can be overcome.

Under the President's plan, an apolitical, independent board would select private-sector investment managers through a competitive bidding process similar to the one used by the Federal Retirement Thrift Investment Board. Investments would be limited to broad-based, widely-used index funds, eliminating the possibility of individual stock picking. Purchases and sales will be dictated by the cash needs of the Social Security system and by the requirement to maintain equities as 15 percent of the Trust Fund, eliminating the possibility of investment decisions based on market timing. In addition, our proposal limits the share of Trust Fund assets that could be invested in equities, so as to ensure that these funds never account for more than a small fraction of the stock market.

Why does the President's plan cause gross federal debt to rise faster than it otherwise would?

A third issue concerns the fact that, under the President's framework, gross Federal debt would rise by more than otherwise would occur, even as debt held by the public is being paid down. Doesn't this signal an *expansion* of the obligations of the Federal government?

Debt held by the public and debt held by the Trust Funds do have equal legal standing. Both are obligations of the United States Treasury. But there are important distinctions that must be recognized. It is debt held by the public that best captures the Federal government's pressure on credit markets, and hence this measure of the debt that is most relevant for determining whether interest rates are high or low, whether private investment in productive capital is strong or weak, and whether we have to borrow much or little from abroad.

While the debt held by the Trust Funds is a liability of one part of the government, it is at the same time an asset of another part of the government. On a consolidated basis, then, it is a wash. By contrast, the debt held by the public is a liability of the *entire* government; it is, therefore, the better measure of the fiscal burden we are passing on to future generations. The Congressional Budget Office has long held this view, and reiterated it in their testimony before the Senate Budget Committee on February 23rd of this year.

Looking at the situation from the perspective of the non-Social Security portion of the government only, the President's program in effect converts an *implicit* commitment (in the form of promised future Social Security and Medicare benefits) into an *explicit* one (in the form of the Special-issue securities, or "Specials", held by the Trust Funds). Putting Specials into the Trust Funds does not increase the amount that we will owe in the future for Social Security benefits and debt. Again, this point was made clear in CBO's February 23rd testimony.

What if the projected surpluses do not materialize?

A fourth issue concerns the prudence of committing today to transfers for as long as 15 years into the future, given the huge uncertainty surrounding budgetary projections. To be clear, the President is proposing that we make the specified transfers into the Trust Funds regardless of whether our current forecast of the budgetary outcome proves accurate. We did not make this policy choice ignoring forecast uncertainty. On the contrary, we fully recognize and appreciate the extent of uncertainty surrounding any economic projection, much less one purporting to peer out 15 years into the future. Indeed, that uncertainty is a primary reason why we believe that a more prudent way to run our fiscal affairs is to substantially pay off the debt held by the public over the next 15 years and, rather than commit today to the consumption of those surpluses over the next 15 years rather than commit today to reduce taxes or raise spending. Under our approach, the real uncertainty concerns whether the debt reduction we actually achieve will be less or more than we currently project. Under an alternative approach, in which government saving is reduced by spending increases or tax cuts, the remaining uncertainty would not concern how much debt reduction occurs in the future, but rather whether there is debt reduction in the future.

Do the bonds we propose placing in the Trust Funds make real provision for the future of Social Security and Medicare?

A fifth issue concerns the question of whether we have made real provision for the future of Social Security and Medicare by placing additional assets in their respective Trust Funds. We believe that we have, in two respects.

- First, we have ensured that a corresponding amount of debt held by the public is taken out of circulation. This is a crucial step toward creating the fiscal capacity to meet our benefit obligations to Social Security and Medicare beneficiaries. Given that we take this step, long-term projections by the Office of Management and Budget illustrate this fiscal capacity by showing unified budget surpluses into the middle of the next century. The overwhelming consensus of economists recommends paying down the debt held by the public as one of the most important contributions the government can make in advance of the retirement of the babyboom generation.

- Second, having created new *fiscal* capacity to meet our obligations, the President's framework provides new *legal* capacity, by assigning the proceeds of the debt reduction

to the Social Security and Medicare programs. Absent this action, Social Security would be unable to pay current-law benefits beyond 2032, notwithstanding that we would have the fiscal capacity to do so. Medicare also would become insolvent early in the next century. To be clear, the assignment of the debt-reduction dividend to Social Security and Medicare does not expand our obligations under those two programs -- it merely expands our capacity to meet existing obligations in a timely manner.

Is it desirable to commit general revenues to Social Security?

Finally, a sixth issue concerns the desirability of committing general revenues to Social Security and Medicare. From the beginning, Social Security has been mainly financed out of a dedicated payroll tax, and a substantial body of opinion has held that the long-term integrity and durability of the programs would best be upheld by severely limiting, if not prohibiting, the use of general revenues.

The President's framework proposes something quite different from general revenue financing as it has historically been contemplated. The framework proposes to tap, for a limited time only, the unprecedented surpluses now in prospect. Importantly, the President's framework is a mechanism for ensuring that the surplus general revenue is used to pay down the national debt, and thus is a vehicle for ensuring fiscal discipline, not fiscal laxity. Such a temporary use of the surplus can be justified by the need for help in the transition of the retirement of the baby boom generation. This is far different from any approach that would either use general revenues in perpetuity, or that would expand benefit obligations.

Concluding Remarks

Mr. Chairman, it is difficult to overemphasize the significance of the changes achieved through the fiscal responsibility of the past six years. It is indeed remarkable that we can sit here today and debate how best to use budget surpluses. I believe it is worthwhile to take a minute to consider how recent economic changes have lifted the weight of an era of deficits off the nation's shoulders to make a new era of surpluses possible.

During the 1980s, the nation's fiscal status quo pointed only to a future of growing budget deficits. As deficits expanded throughout that decade, the volume of our nation's debt grew, meaning that the government's interest payment obligations were put on a path of continued growth. At the same time, health care costs of the federal government were rising relative to the size of the economy.

Today, by contrast, the situation has been reversed, and the basic momentum is toward improved budgetary performance. Important legislative steps toward deficit reduction were taken in the 1993 Omnibus Budget Reconciliation Act and the 1997 Balanced Budget Act. And over the past several years, health care costs have been rising more slowly. As a result, today's basic fiscal setting involves large and rising unified surpluses, which -- provided they are preserved -- will

allow us to pay down the debt held by the public.

When President Clinton took office, the fiscal trajectory our nation was on suggested that by 2014, the government would be devoting 27 cents of every dollar it spent to interest payments on the federal debt. Instead, as a result of the course we have charted, only 2 cents of every dollar of outlays will be needed to cover interest expenses 15 years from now — a savings of about $1 trillion in that year alone. The challenge we face in allocating the surpluses to the best possible use is to ensure that the underlying momentum toward fiscal control is maintained. By devoting the lion's share of the surpluses to debt reduction and preserving Social Security and Medicare, the President is ensuring that we devote the surpluses to the best possible use to help cushion the impact on future budgets as the population ages. Thank you. I would now welcome any questions.

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The CHAIRMAN. I did not mean to interrupt you. I thought you were done, but you were saying you were done but you said, "In conclusion." We appreciate your testimony very much. You have been a point person for so many policies for the administration.

I know how busy you are and taking time to come on this very important issue for this committee shows the commitment of you personally to this issue as it does show the importance of the issue to the administration and hopefully reflects the importance of this committee in this legislative debate.

So once again, thank you for being here. Each member may take 5 minutes for each round. The President's plan has been complimented by some and by others it has received some criticism, both for proposing this sort of collective investment you are talking about and for financing Social Security benefits from the larger general revenue transfers.

For me, though, I am most concerned that the President's initiatives seem to leave us in this limbo that I referred to in my opening remarks, whether it is sooner or later and whether the years be 2040 something or 2060 something, if we follow the President's proposal to a tee, we are still going to have a situation down the road where there is a bankruptcy in the system like we now see for the year 2032.

At that point, we do one of two things. We either increase taxes from 12.4 percent where they are today to 18 percent or you reduce benefits by a third. So like I say, it seems to me that we are left a little bit in limbo. I have talked to people in the administration who have said, well, we have got an opportunity for a bipartisan effort.

As I also indicated, it seemed to me that everything that the President has put on the table up to now has been the easy lifting type stuff. The really difficult stuff comes down the road, so a very simple question.

Will the President be putting forward some changes in Social Security that will get us to that point where we have the 75 percent solvency that we have always had as a target?

Mr. SUMMERS. Mr. Chairman, I would take issue with two things in your question. First, I do not think it is pain-free to commit 62 percent of the surplus and remove it from the power of the political process to cut taxes or to propose new programs. I think that does represent a painful step and I think it represents a step that by eliminating debt and saving future interest payments does provide directly for financing of future Social Security benefits.

Second, the President expects to work in a bipartisan process to develop the additional measures that would be necessary to carry us from 2055 until 2075 and I think that is a very important part of this process. My understanding is that our preference would be to do that in a bipartisan way for reasons that I am sure you can appreciate, that I think any such proposal involving structural changes has a much better chance if it is a proposal that is developed with a lot of consensus building beforehand.

If I might make one final comment? I would not minimize, Mr. Chairman, the significance of solving two-thirds of the 75-year deficit and providing for adequate guaranteed Social Security benefits at current levels out to 2055.

Nor would I minimize the risk that if we do not take this step and we use the surplus for other purposes, no matter how valid, we will find ourselves in a situation where we will no longer be able to realize those interest savings and where the challenge of saving Social Security will become that much more difficult with those 18 percent taxes and 32 percent benefit cuts that you referred to in prospect.

We could avoid two-thirds of that by preserving those surpluses right now for Social Security and I think that is an important step for us to take even as we address what is also crucial, the structural challenge you mentioned.

The CHAIRMAN. The President's proposal, and I think you probably emphasized this, is based upon projections, and I think my way of saying you emphasize that, you said that for 7 years in a row, the President's economists have under-estimated the amount of growth that we would have.

Over the long-term history of government, estimates have not been so good in most of my years in the Congress. I tend to be very cautious when it comes to this.

So my next question would be based on a premise you might not agree with, but if the projected surpluses do not materialize, are we locked into then to a policy that transfers revenue to the trust fund whether those surpluses are there or not, and isn't that a huge burden then on our children or grandchildren in the sense of increased taxes at that point or some reduction in expenditures at that point?

Mr. SUMMERS. Mr. Chairman, with respect, I would suggest exactly the opposite. Let us assume that the projections were to prove substantially too optimistic and the budget situation were not to materialize as predicted.

Under the President's plan, we would find ourselves in a situation where we would nonetheless be providing a substantial transfer to the Social Security system and that would be something that would be reflected in our budget accounts and we would be continuing to reduce the burden of debt held by the public, which does damage to economic performance by crowding out investment.

On the other hand, if we were to pass up the opportunity to take this step and we were instead to enact other permanent programs or tax cuts with these surpluses, then we would find ourselves in a situation where in 2008, or some such year, the national debt would actually start rising again, the crowding out effects would be increased, and we would be back in the kind of very unfortunate dynamics we were in in the 1980's and very early 1990's.

The President's program is assuring that these resources will be used to reduce the national debt. Therefore, it is very much preferable on fiscal grounds to simply leaving the surpluses to be dissipated by spending programs of tax cuts.

So I think the argument for the President's program is actually magnified once you recognize that there are enormous uncertainties associated with these projections because that is what makes it so important to find a political device that will enable the policy to preserve the surpluses that are projected.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Well, thank you very much, Mr. Summers, for being with us on this very challenging program and the problems that we have with it.

I was looking at the transfer of what, $2.8 billion in surpluses?

Mr. SUMMERS. Trillion.

Senator BREAUX. Trillion dollars in surpluses in to the Social Security trust fund. Then you point out that we have to do more than that, and some of the things that you are talking about doing more is eliminating the earnings test; doing more for widows, children, and disabled; using 12 percent of the surplus to create the retirement accounts, universal savings accounts.

It seems like all of the things that we are talking about doing more of in order to reform, all of it involves spending more money. When we are talking about tough choices, maybe we need another commission, which I would hope that I would not be on, and it is called the "Pain" Commission because every time there is a lot of pain in solving some of these problems, we do not get around to doing it.

I mean, we are talking about adding a lot more benefits, which I think is wonderful, but you have got a program that is going broke and there are some things that are difficult to do without looking at some things.

I mean, the CSIS Commission, which I did serve on in the private sector, talked about a CPI adjustment. There is nothing here mentioned about that. We talked about looking at the age requirements; nothing in here about that. Where are the hard choices?

Mr. SUMMERS. I think it is a very important question that you ask, Senator Breaux. The key structural changes that the President proposes in Social Security, the widows benefit and the earnings test. The widows benefit, which is a very important issue, does have an additional cost.

My understanding is that one can do a great deal for the people that Senator Hutchinson and Senator Lincoln spoke about in their statements, at a relatively modest cost, one or two-tenths of a percent in terms of the payroll, in terms of the 2.19 percent payroll.

The elimination of the earnings test has essentially no cost averaged out over the 75-year period because of the fact that there are actuarial reductions for people who retire early. So the incremental costs of the President's steps with respect to Social Security is small. The USA accounts are outside of Social Security and the budgetary allocation.

There is, to be sure, the question of getting the last 20 years, from 2055 to 2075, and there I can only reiterate my earlier answer, Senator Breaux, which is the President's conviction that it is best for those to come out of a bipartisan process and one that he is eager to enter into if there is that bipartisan desire in the Congress.

There is, as your question suggested, a list of potential structural reforms that I think at this date people are aware of and the primary choice that needs to be made is a political one between alternatives, which certainly do have the consequence of impacting on either benefit levels or tax levels, but as important as that is——

Senator BREAUX. It sounds like we are headed to another commission.

Mr. SUMMERS. Well, another commission or a bipartisan process. Just what is the best way is not something that I suspect we will be able to work out here, but I would emphasize—I think this is a crucial point—that as important as that is, it should not blind us to the importance of taking steps to ensure that the surpluses we now have are preserved so that we get that extra fiscal space in 2030.

There is 3 percent of GNP in extra fiscal space, room to meet these obligations that is potentially available by preserving the surpluses right now. It seems to us in the administration that it is of overwhelming importance that we take decisive action to make that fiscal space. Then once we have made that fiscal space, to make it available to the programs whose costs are inevitably going to rise and that is the basis of our approach alongside the bipartisan process to do the difficult work.

Senator BREAUX. We have, for the first time, a proposal and, I take it, for the first time, to use general revenues to finance Social Security which has always been financed through the basic 12.4 percent payroll tax.

Now, there were some in Congress who said, we solved a portion of Medicare in the last Congress because we took some of the programs that were being paid for by the Medicare trust fund and put it into general revenues under Part B and say, we solved the problem. We are just having it come out of general revenues.

It is a very legitimate concern among Members of Congress that if we are going to have two programs, it is going to eat up all the discretionary money in this country in the direction that we are heading and it is a very serious bipartisan concern.

So maybe just explain philosophically—I mean, this is a major change. We are using general revenues to pay for something that was subject to a payroll tax over the years and it was a guaranteed amount. Now we are saying, well, the surpluses, we hope they are there, so we are going to start using general revenues for the first time to pay for a program that was based on a payroll tax. This is a huge change. I am not arguing pro or con on it. I am just saying it is a huge change.

Mr. SUMMERS. It is a change, Senator, but I would argue that it is a different change than that that has been contemplated in traditional discussions on general revenues. There you were talking about basically taking a permanent tax stream from general revenues and allocating it to meet an entitlement program's costs.

Here we are talking about a budget surplus that we have accumulated and that we can foresee over 15 years that if we do not do something with it will, in all likelihood, be dissipated in the form of other new programs or other changes in the tax system.

We are taking that temporary increment to the surplus and on a temporary basis making a provision for strengthening the trust fund. That is a very different thing than providing it on an ongoing basis for—which has traditionally attracted a great deal of concern, rightly in my view. That is very different from an ongoing general revenue stream to meet an ongoing entitlement expenditure, which I think is highly problematic.

A temporary set-aside of a surplus to meet a coming obligation is exactly what a corporation would do in a very profitable period

when it had a large pension liability coming due, and I think, really reflects what is the best financial practice, which is to take advantage of a transitorily good time to meet a subsequent time when there is going to be much greater financial strain.

So in that way, it differs from the traditional general revenue discussions, but certainly it does represent a departure.

Senator BREAUX. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hutchinson.

Senator HUTCHINSON. I am not sure, Secretary Summers, whether I understood. It sounds like a difference without a distinction. How long is this temporary set-aside?

Mr. SUMMERS. Fifteen years.

Senator HUTCHINSON. Fifteen years. Let me move for just a moment to another part of the President's proposal. A number of Government officials, including Mr. Greenspan, have expressed concern in testimony before Congress about the President's proposal to invest some of the Social Security trust fund in equities.

In testimony that we will hear later this afternoon, it is suggested that the President's proposal overstates what the stock market returns would be. The President's budget assumes a 6.75 percent return. However, the trustees have projected that economic growth over the next 75 years will average only half the rate of the last 75 years.

If that is the case, the return on stock would only average about 4 percent. Taking into account transaction and brokerage fees, return could be less than that, 2 to 3 percent. In comparison, the trustees project that Treasury bonds will pay 2.8 percent on average.

So could you deal with that issue of the 6.75 percent as the basis for that projection?

Mr. SUMMERS. Yes, Mr. President—Mr. Chairman.

Senator HUTCHINSON. It is a big leap.

Senator BREAUX. They are all from Arkansas anyway.

Mr. SUMMERS. Senator, let me deal with it by making three points if I could. First, the 6.75 percent estimate that is in the administration's proposal is the estimate of the Social Security actuaries who work for the Social Security trustees.

Second, while it is a somewhat technical subject, the judgment that economic growth will be slower over the next 75 years is, to a large extent, a judgment that our population will grow less rapidly than it has in the past. The fact that our population will grow less rapidly than in the past is really no reason why the expected return each year on the stock market should be lower than it otherwise would be.

Indeed, if you look at the way private sector corporate pension plans are funded, or you look at the way State and local pension plans are funded, or you look at the assumptions that go into other Federal pension plans, you will find that that 6.75 percent number is, if anything, conservative relative to the assumptions that are made by analysts who are looking at projected stock market returns in the future.

Certainly there is no guarantee about how the stock market will perform. It has averaged 18 percent return over the last 16 years.

Senator HUTCHINSON. So you just reject their projection? I mean, the fact that the population would grow slower, that there would be lower productivity or whatever, that is what you are saying?

Mr. SUMMERS. No. I accept the projection that the population will grow less rapidly, but the fact that the population will grow less rapidly is something that they are very much aware of when they also project that the stock market will have an average return of 6.75 percent.

So I reject the premise of your question, that the fact that the population is going to grow less rapidly is a reason why one should revise downwards of one's estimate of the expected stock return. I would rather use the assumption that is used commonly and pervasively in the private sector, which is, if anything, somewhat greater than the 6.75 percent figure.

Senator HUTCHINSON. That was not my assumption. I was simply going by the trustees. My understanding of the trustees' projection that the growth could be expected to be about half.

Mr. SUMMERS. Senator, you are correct that the trustees predict that growth will be slower. However, even projecting that growth will be slower, they are the source of the 6.75 percent figure.

Senator HUTCHINSON. All right.

Mr. SUMMERS. So we are using an assumption that is the actuaries' assumption and I am providing the additional information that that assumption is, if anything, a little bit conservative compared to that that is standard practice in the private sector.

Senator HUTCHINSON. OK. The President, as has been mentioned, we have not heard recommendations on fundamental reforms, that is what we all would like to come up with and you say we need to do that on a bipartisan basis. We would look for Presidential leadership.

He, in his Social Security forum in Kansas City last April, ruled out both a FICA tax increase as well as eliminating the cap on taxable wages. Has the President taken any other proposals off the table, ruled out any other suggested changes, and is there the prospect that there will be recommendations from the administration on these kinds of systemic, fundamental reforms?

Mr. SUMMERS. I think the President has come forward with a framework for a solution and concrete measures that will solve two-thirds of the problem. He believes it is now appropriate for that approach to be considered and for a bipartisan process to take us the rest of the way to a 75-year actuarial balance.

He and his colleagues in the administration are very much prepared to take part in such a bipartisan process on terms that, in a bipartisan way, members of the two chambers of Congress believe is best.

Senator HUTCHINSON. He has taken to things off the table. Is he going to put anything on the table as far as specific proposals?

Mr. SUMMERS. I think we believe that the best way forward from this point is in the context of a bipartisan process, which we think can build on what I think represents a very important contribution of two-thirds to the solution of this problem.

Senator HUTCHINSON. Who is going to make the initial things to react to? I would think it is the President and the leader of the executive branch, specific proposals on how we reform, make the

kinds of changes where we do not have the bankruptcy here or bankruptcy there kind of alternative.

Mr. SUMMERS. Well, I suspect it is going to be difficult for either of us to surprise the other at this point, but I would just remark that the President has put forth a framework that relies on use of the surpluses that solves two-thirds of the problem and points toward the solution of the remainder and believes that the right way to go forward on the rest of it is through agreeing on what kind of bipartisan process can build consensus on the whole package.

Senator HUTCHINSON. Thank you, Mr. Chairman.

Senator BREAUX. We are going to hold hands and jump off the cliff together.

Senator HUTCHINSON. It might work.

The CHAIRMAN. This is the way Senators arrived, so I will call on Senator Hagel, then Senator Lincoln, then Senator Bryan, then Senator Bunning, and then Senator Bayh. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you. Mr. Secretary, thank you for coming up today.

You have recently been engaged and still are in the international economic crisis that is perplexing all the globe. Based on that and your other experiences in life, let me ask you this. Do you have confidence in 15-year projections?

Mr. SUMMERS. I think 15-year projections have the potential for enormous plus or minus errors in either direction. As one example, the projections made in 1993 for 1999 had an error of a few hundred billion dollars, and that error, fortunately for all of us, turned out to be an error of excessive pessimism in those projections.

There is certainly the prospect of future errors that would prove to be in the direction of optimism. That is why we think it is important to find a politically effective device for walling off a large portion of the surplus so that it cannot be spent and so that we will be able to continue reducing the national debt even if it were to turn out that conditions did not materialize in as favorable way as we wanted.

Senator HAGEL. I guess that means you do not or you do have confidence in 15-year projections?

Mr. SUMMERS. Fifteen-year projections have enormous potential for error in either direction, absolutely. No one can have total confidence in them, but there is no alternative to relying on the projections we can make at this point. But certainly, they have got enormous potential for error.

Senator HAGEL. So that would lead one to believe that there would be some caution needed as we project out if we are to use those projections to base any of our out year projections as to how we come to a resolution on this most important issue?

Mr. SUMMERS. Certainly and the only thing that requires more caution than a 15-year projection is a 75-year projection, which is what we always have to rely on when we target 75-year actuarial balances.

Given all the uncertainties we have in the future, the President's concrete approach, which preserves these surpluses and removes the temptation to dissipate them, becomes all the more important.

Senator HAGEL. Doesn't that then lead us all back to the same uncertainty and that is, what are we going to do about structural reform?

Mr. SUMMERS. Certainly structural reform has an important role to play, but I believe that we can actually get more than half-way, about two-thirds of the way, through the combination of realizing the easy budget space we can make. We can make 3 percent of GNP, 13 percent of the Federal budget, in extra space in 2030 simply by now concentrating on reducing that national debt.

I believe that the most politically sustainable way of reducing that national debt is to earmark the savings from deficit reduction for these programs. So yes, I share your view very much on the importance of structural reform, but I think it is important to take the first step, which is to ensure that we do not dig our problem deeper by dissipating these surpluses that have materialized.

My fear is that if we do not get ourselves into an agreement on the importance of preserving those surpluses, that we will dissipate them while we are debating other possible structural reforms. Certainly structural reform is absolutely critical.

Senator HAGEL. I think at least this Senator certainly could agree and I think from what my sense of this is up here, that most elected representatives, either Republican or Democrat, have committed themselves to whatever surpluses there are coming in from payroll taxes to be used for Social Security should be used for Social Security.

So I do not think that is as debatable as some might think. But getting back to structural reform——

Mr. SUMMERS. But I think, respectfully, Senator, we have always had the practice where all the revenues to come from the payroll tax have always gone into the Social Security trust fund. That has been the case since 1938.

I think the question that we face now at a time when we have a unified budget surplus and a time when we are reducing our national debt by, in a couple of years, two and three hundred billion dollars a year, I think the question is, how are we going to use those unified surpluses which are going to reduce national debt.

Are we, as the administration suggests, going to use them to reduce national debt and assure that continues by dedicating those reductions in the national debt to Social Security or are we, as many would suggest, going to use those unified surpluses to finance new tax cuts or new expenditures programs, which would potentially put at risk——

Senator HAGEL. Well, no one is saying that.

The CHAIRMAN. We are beyond that.

Senator HAGEL. Yes, we are beyond that. That is exactly my point. We are beyond that. So I think we are debating something that left the station a long time ago.

On the issue of structural reform, I want to get back to a question Senator Hutchinson asked about what the President proposed in his State of the Union message on investing Social Security funds in equities.

I think there was a slip there between the question and the answer. Isn't the real issue there the Government investing those funds in equities versus the private sector?

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Mr. SUMMERS. Oh, I may have misunderstood Senator Hutchinson's question. That certainly is a critical issue. There has been, as you know, some data introduced suggesting that State and local public investments perform less well than private investments. That data has now been very carefully examined and what I think the record will show is that is because State and local governments have invested more conservatively and stayed out of equities.

Senator HAGEL. So you would support having the Government, the Treasury invest in equities, having them manage that investment?

Mr. SUMMERS. Well, we would not support the Treasury doing so, certainly. We have got enough to do.

Senator HAGEL. Or the Federal Government or the Small Business Administration.

Mr. SUMMERS. We would support an independent board who would hire private managers to invest in equities only along an indexed fund basis. So completely non-discretionary, autopilot investing is something that we believe would have important potential to avoid what would otherwise be a 5 percent or more across-the-board benefit cut.

Senator HAGEL. Thank you.

The CHAIRMAN. Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman. In rural America, there is a great old pastime where people take a block of wood and they start to carve it. It is called whittling and if you do not have a vision of what you want that block of wood to become, you can easily whittle away that block of wood until you have nothing.

I just want to thank you for making the point that we have a very great opportunity right now with the budget surplus and that the possibilities of whittling it away without having the vision of what we want to accomplish with that surplus is a very dangerous thing that we are handling right now.

I hope that we will focus on preserving programs like Medicare and Social Security that mean a great deal to this country and to the people of this Nation.

I have got a couple questions, a little bit on the flip side of what my colleagues were asking about, the equity market, and I think you answered in your testimony some of that question about the concerns they had about how that would be administered.

The critics of the equity investment, some say that Congress could interfere with the monetary policy and cause stock and bond markets to crash and I would just like to hear your opinion.

The second question would be, I understand that the President's proposal does reduce the public debt, which is obviously a very good thing, but I would also like to focus on what it does for Social Security, does it really add new debt to the Social Security trust fund?

Aren't we again leveraging the trust fund at that point in these new initiatives, these new bonds that are being talked about to further the livelihood of that and what does that mean to Social Security?

Mr. SUMMERS. Thank you, Senator Lincoln, for those two questions. On your second question, the President's proposal does not

contemplate the Social Security system taking on any new obligations. It constitutes providing greater wherewithal to meet the obligations that have already been taken on by eliminating—scaling back the national debt and reducing interest burden.

And then taking the proceeds from those savings and dedicating them to the trust fund so as to give a legal substantiation to the fact that those savings would go to Social Security and Medicare.

So it certainly does not represent any increased risk-taking for the trust fund or any leverage of the trust fund in the traditional sense of the term leverage. What it does represent is fortification of the trust fund—fortification of the assets of the trust fund without any change in the liabilities so it makes it financially healthier.

On the stock market question that you raised, clearly with millions of Americans investing a significant portion of their savings in the stock market, the stock market will attract the attention from time to time of policymakers.

I think it is best, and this is the approach that we in the administration have pursued, to concentrate on the fundamentals of the economy and if we make the fundamentals of the economy be right over time, markets will take care of themselves and that is the approach we favor.

I would not expect that having the Social Security pension fund invested in a small part in the stock market would change that basic political calculus. After all, right now, 10 percent of our stock market is publicly owned. It is publicly owned by the pension funds of State and local governments.

The maximum increase that is contemplated in the administration's proposal would simply be another 4 percent. So while that is quite material to the economics of Social Security, in terms of the overall dynamic of the way in which the stock market functions or the way in which our macroeconomic policies are carried on, I do not expect that it would represent any large change.

What it would do and which seems very important to us is it would provide—because the alternative to it again is benefit cuts or tax increases—what it would do is provide the lower half of our population, which does not really have the opportunity to benefit from the returns the stock market can provide, the same kinds of opportunities to provide for their retirement that the upper half of our population has had.

And by doing it collectively, which is implicit in the administration's proposal, you have three important advantages over some suggestions that this be done on an individual basis. One is that the risk becomes the Government's risk to smooth over time rather the individual's. Second, you preserve the progressivity of Social Security. And third, you preserve what is quite remarkable, which is that nearly 99 cents out of every dollar that Social Security collects goes to pay benefits.

If you look at private annuities or you look at the systems in Chile or England, it is 20 cents, 25 cents, or even more that is going to the various middlemen, and that is an important virtue of this kind of approach as well.

Senator LINCOLN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. Mr. Secretary, welcome to our hearing.

Let me say at the outset, I would commend the Administration in terms of the framework that it has outlined to the extent that it seeks to accomplish two important objectives. One, to prevent the watching of massive new spending programs, and second, to help us to reduce the very politically and attractive temptation of providing a substantial, across-the-board tax cut.

I think neither of those are appropriate policies for us to pursue. The concern I have, though, is that most of us, when we try to explain this proposal back home, are not dealing with a graduate seminar at the Wharton School of Finance. We are not talking to the American Institute of Certified Public Accountants.

We are talking to average folks, some of whom have as much, if not more, education than we do, but who are not necessarily people that make the distinctions between this esoteric debt terminology.

I have elected not to run in the year 2000, so let me cite myself as an example. I am back home explaining this proposal and I say the good news is that we are going to reduce public debt by a substantial amount, and the figures are indeed dramatic, and that is one of the reasons why we ought to support this, among a number of others.

And then a fellow on the other side of the room says, but, "Senator, isn't it true that you will have to vote to increase the debt ceiling at the same time?" Now, as I said, I am not running for anything, but it strikes me that having to increase the debt ceiling is a very, very powerful argument to be made against this proposal.

For those of us who came to Washington with State backgrounds, such as my colleague, Senator Bayh what alarmed us in the 1980's was this massive piling-on of the debt. We went from less than a trillion dollars in 1980, to a decade later with more than $3 trillion, as I believe the number is, and you will correct me if I am wrong, Mr. Secretary, but in the range of $5.6 trillion.

So help me to explain to these good folks, and I do not want to give you the impression that folks out my way are any less swift than in any other place in the country.

The CHAIRMAN. They just proved how swift they were by the answer you got.

Senator BRYAN. How do we explain this? Because I do not think most folks make any distinction between public debt and this esoteric debt of the trust funds. So give me an explanation that I might give this summer when I am out there in Winnemucca, NV, discussing this proposal to the good folks at the senior center.

Mr. SUMMERS. Let me first say, Senator, I had taken note of your announcement of your retirement with regret.

Senator BRYAN. I appreciate that.

Mr. SUMMERS. Many people in Washington will miss you.

Senator BRYAN. Thank you.

Mr. SUMMERS. I hesitate, given my background, to try to give you advice as to how best to speak to the people of your State in a clear and effective way.

One analogy that might have some possible appeal would be this. Imagine yourself, the treasurer of General Motors, and how would you think about two different kinds of debt. One is General Motors'

debt that it is going to have to pay off to the public. The other is debt that Chevrolet is going to have to pay Buick.

It is entirely within your corporation. Those are two very different things. I think from the point of the treasurer of General Motors, the debt that he is going to have to pay to the public represents a much more serious problem, a claim on his future earnings, a reduction in his net worth; whereas, the transfer that is inter-corporate between Chevrolet and Buick is a very different kind of thing.

In just the same way, that is why every economist—and in almost all the stuff here, you could find conservative economists, liberal economists disagree about, but that is why every economist will tell you that this intra-Federal Government debt has tremendous accounting and political significance, but does not have economic significance, just like debt that is payable between Chevrolet and Buick does not have any economic significance.

If we wanted to do the debt limit, the debt limit has been done the way it has been done because that is the way it has always been done. But if wanted to do the debt limit in a way that was economically meaningful with respect to the burden on future taxpayers, then we would not—we would do it in terms of the publicly held debt.

Or think about it this way. What is the liability of the American taxpayer? The GM shareholders—that is the way to put it. GM shareholders do not have a liability when Chevrolet owes Buick money because they are shareholders in both.

The American taxpayer does not have a liability on the intra-Federal Government debt. What they have a liability for is the debt that the Federal Government owes to the public.

Senator BRYAN. But the general fund would be obligated, would it not, in future years to be making those general fund payments to the Social Security?

Mr. SUMMERS. Sure, but that would just be the counterpart of—that is correct. But that is just a counterpart of an obligation that the Nation has anyway. The ultimate obligation the Nation has is the obligation to pay the promised benefits.

Whether there are bonds there or whether there are not bonds there, the Nation has the obligation to pay the promised benefits. So you are not taking on any increased—the Nation is not taking on any increased obligation. It is simply making tangible the obligation that it already has.

Mr. SUMMERS. I appreciate that. Thank you, Mr. Chairman, and thank you, Mr. Summers.

The CHAIRMAN. Senator Bryan, the bottom line is that you still will have to vote to increase the national debt, so that constituent was right. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. Can I inquire of the secretary why the President's current proposal to wall-off 62 percent of the budget surplus is better than 90 percent?

Mr. SUMMERS. The President——

Senator BUNNING. You know, the bill we had last year walled off 90 percent of the surplus. The administration was strongly against walling off 90 percent of the surplus last year. Now I want to know why 62 percent is so much nicer.

Mr. SUMMERS. I would draw two distinctions, Senator. One is that to my knowledge, the bill that was proposed last year would have committed the 90 percent to Social Security, but would not have provided that that 90 percent would be used to augment the trust fund in a way that the administration's proposal calls for.

Senator BUNNING. Walled off and could not be spent and could not be recycled in new debt. That is what the bill said. Isn't that paying down the debt by not recycling it out?

Mr. SUMMERS. I think it was indeed—I think it indeed did provide—you know the bill much better than I, Senator. But I think that while the bill probably did provide for those resources to be used for reducing debt, it did not provide for those resources to be explicitly committed to the Social Security trust fund.

Senator BUNNING. But it did.

Mr. SUMMERS. And that is what this is about. The President has made a judgment that this 62 percent is appropriate in the context of an overall solution for Social Security. The bill last year——

Senator BUNNING. So was the bill that we passed last year in the house.

Mr. SUMMERS. I think the bill last year, as I understood it, would have allowed the 10 percent of the surpluses to be used for the tax cut prior to an agreement on a full Social Security solution.

Senator BUNNING. Dependent on when the tax cut would have been phased in or when it would not have been phased in.

Mr. SUMMERS. Well, you know, in different circumstances, it might have been possible to find some common ground. The crucial point about the President's approach is that he wants to preserve 100 percent of the surplus until we have found a satisfactory Social Security framework.

He believes we can find a satisfactory Social Security framework using 62 percent of the surplus, but that the whole surplus is to be preserved until we have found agreement on an appropriate Social Security framework.

Senator BUNNING. Thank you. A hundred percent we will have a unified budget surplus over and above the Social Security surplus in the year 2000–2001, depending on how much the unified budget surplus is in relationship to the Social Security surplus, but I am not going to get into splitting hairs because it may be in 2000, it may be in 2001.

Mr. SUMMERS. Well, the President's hope would certainly be that this year, we succeed in coming to a bipartisan approach on a satisfactory Social Security framework and if we do, there is likely to be some residual left over which can be used to meet other needs in USA accounts and so forth.

Senator BUNNING. Mr. Secretary, in 1988, a group of freshmen called the Class 100 freshmen, proposed to do away with the earnings limit in 1988. In 1994, we succeeded in raising the earning limit up to $30,000. We worked very, very hard. In the year 2002, the earnings limit will reach $30,000.

Your bill proposes to eliminate it completely. I applaud you for that, for resisting for so many years the fact that we wanted to do it. We could not get the Bush administration to do it, we could not get the Clinton administration to do it.

I applaud you for including it in your bill because it is one of the biggest detriments to keeping our seniors occupied and self-worth after they are 65 years old so that they can earn more without being penalized. So I applaud you for that.

My big problem with your proposal is that the Federal Government cannot do better than the individual investors if you allow the individual investors certain choices. In other words, if you allow a limited amount of investment opportunities like in our Federal 401(k) plan, the same thing can be set up for the Social Security retirement accounts or private investment accounts, or whatever you want to call them, only adding on to the three already available, two more in the year 2000, and five more by the year 2010.

So with the same board, with the same oversight, with the ability not to draw it out, everyone—and I sat 8 years on that subcommittee over in Ways and Means, both as Chairman and as Ranking Member with Andy Jacobs. We both had the same. We got your reports. We got the President's reports on Social Security.

All had personal investment accounts some way or the other in their recommendation. The Federal Government ought to allow the Social Security recipients to have a choice. That is one of the political policy options that if we do not get we will never get the AARP or the Committee to Preserve Social Security and Medicare or any singular senior group to support anything we do because they will resist to the death the change in benefits for anyone on Social Security or anybody about to go onto Social Security if we do not give our young people the option voluntarily to choose something else.

I would like your—you know, why you so oppose, and I have heard the other explanations.

Mr. SUMMERS. Thank you, Senator Bunning. First, I appreciate very much what you said on the earnings test and this is an example of something I think we can probably all here agree on is very important, which is that we do this in a bipartisan way and that we look hard and just try to find the best way forward, so I appreciate very much your comments on that.

On the investment side, I think there is a lot to be said for assuring that every individual has savings that they can manage. That is why an important part of the President's overall package is the USA accounts which represent the step in exactly that kind of direction of a universally available savings vehicle.

On the question of individual accounts and the relative returns from individual accounts versus collective management, I think the crucial points there are two. The first is that with collective management, you do allow for much greater risk-spreading because it becomes the Government's obligation to provide a guaranteed benefit and then to manage the risks.

If, for example, you had a situation like the one that the United States had in 1974 when the stock market fell by 67 percent, about 67 percent in real terms, you would face the situation where an individual who had been building his individual account, was unlucky enough to retire that year would see an enormous decline in their benefits.

On the other hand, in the collective investment approach, it would still be a guaranteed benefit. The Government would have

an opportunity to take advantage of the fact that the market swings up and swings down and we would be able to average that out——

Senator BUNNING. In that case, Mr. Secretary, your overall 75-year projection would be falling short, too.

Mr. SUMMERS. The projection would fall short, but as long as there—we have got fairly elaborate statistical work illustrating the point I am making. As long as the market has a tendency to swing up and down, the fluctuation in the overall 75-year balance would actually be very small from a single year's fluctuation in a fluctuation in the stock market. I will submit something for the record that can explain that, that can quantify that in a little bit more detail.

The other point is that once you move to individual accounts, particularly if you provide for multiple vendors for the individual accounts——

Senator BUNNING. I did not say that.

Mr. SUMMERS. OK. With no multiple vendors for the individual accounts, you still had some extra costs from processing, the ability to make the choices and to allocate between this place and that place. The Federal Thrift Savings Plan is a terrific program, but its costs are reduced by the fact that, for example, the U.S. Treasury as it writes my payroll check, is prepared to take on a set of obligations that I suspect small businessmen would be quite reluctant to take on on behalf of their employees.

So you still have some savings from the collective investment approach, and that is the case. So it is the risk case and it is the administrative cost case that I think represents the advantages of doing Social Security this way.

But fundamentally, we agree with what I think is your central point, which is that people have to be given some kind of account in which the Government helps them save for their retirements and that has to be something that is available for every American.

Senator BUNNING. Well, that is a good starting point.

Mr. SUMMERS. And that is what the USA account is.

The CHAIRMAN. Senator Bayh.

Senator BAYH. Thank you for being here, Mr. Secretary. I apologize for being a little bit late. I was coming from home today and our plane had a little mechanical difficulty, so I am glad to have arrived and I hope my questions are not redundant of what you covered in your opening statement or what some other members covered earlier in their opening statements.

I want to congratulate you. I am very interested in the notion of paying down the national debt. I understand very well the virtuous cycle that that could set off of lower service payments on the debt, freeing that up for meeting our Social Security obligations; freeing up capital for productive investment in the private markets, and allowing the Government, should the need arise again, to enter those markets without disrupting the private sector's investment needs.

I have encountered a couple of skeptics, let's call them however, who say to me, Evan, we understand the economic theory is perfect, but we just know that you politicians will find spending increases or tax cuts much more politically desirable and you will just never get around to doing it.

Chairman Greenspan, last week in his testimony—in my previous incarnation, by the way, as a member of the Banking Committee, we heard from the Chairman and from Secretary Rubin last week, so in addition to your testimony today, I feel as if I am well along my way in doctoral work on public finance.

Chairman Greenspan indicated that paying down the debt has many of the same virtues as cutting taxes. If I could just ask you to take one moment, if you were speaking to the people of Indiana, could you please explain to us, in clear terms, why paying down the debt should be as attractive to us as either increased spending or tax reductions?

Mr. SUMMERS. I do not know whether I was effective or not in suggesting a way of speaking to the people of Nevada and I am not sure how I will do for the people of Indiana, but I guess I would just make this point. First, by paying down the debt now, you make room for lower taxes in the future or, if that is what people desire, you make room for increased spending in the future because you reduce the burden that is put on the Government in the future.

Fifteen percent of what we are spending now we will not have to spend anymore—13 percent of what we are spending now, we will not have to spend anymore if we are able to eliminate the national debt. Why do it now? Because not only does each dollar of debt we pay down now avoid a dollar of taxes that we would otherwise have to collect 10 years from now, it is a dollar plus 10 years' interest, which makes it almost two dollars that we save.

So by buying down the debt now, we reduce the tax burdens that we are going to have in the future by much more than dollar-for-dollar. We also help our economy because every government bond that someone has to hold is a dollar that if it did not have to go into that government bond would be able to go into tools for American workers or homes for American families.

Every dollar that is not out there, every bond that does not have to be sold is less pressure on the nation's credit markets, is lower interest rates, and that is another way that it functions like a tax cut. A 1-percent reduction in the level of interest rates is equivalent to a tens of billions of dollars tax cut because of what it means for all those Americans with variable rate mortgages.

So in all of those ways, it is doing the same thing as a tax cut. It is doing it better and it is doing it much larger.

Senator BAYH. Thank you, Mr. Secretary. Just a couple of other quick questions. By the way, many people I have encountered also consider this to be the more conservative approach, paying for our future obligation so that our children and grandchildren will not be burdened with our own excesses.

I had some members of the United Auto Workers in my office last week. They are a good group. They were out here on convention and they wanted to come see me and I was delighted to have them. One of the very first things several of them said, I remember a man took me by the arm and he said, please, please do not put our Social Security at risk.

It occurred to me that this same gentleman probably had his pension or at least a part of his pension through the United Auto Workers invested in the equity markets and that there are other

risks attendant to not moving forward to try to generate a higher rate of return for the taxpayers' Social Security funds.

If those individuals were here today, could you please discuss the risk involved in this program and why, in your opinion, it is an acceptable one?

Mr. SUMMERS. Here is a way of framing that. If you look at Social Security benefits in some year in the future, say, for example, 2030, for each dollar of Social Security benefits in 2030, 72 cents will be paid for by the payroll tax stream that is available in 2030. That is pretty safe. That is there.

The remaining 28 cents will come from the trust fund. Eighty-five percent of the trust fund is to be invested in government bonds, full faith and credit of the United States, no default in 200 years.

So all that is being invested in equities is 15 percent of the 28 percent, which is about 4 percent. So it is only 4 percent of benefits that depend at all on the stock market. If you go back 200 years, there has been no 30-year period in our history, not a single one, where the stock market over 30 years did not out-perform the bond market.

So it is only 4 percent of the benefit that is at stake in any event, and all of the history suggests that we will be better off with the investment in the stock market. Even if that were to be wrong, it would be the Government's obligation and you would simply get into a situation where the program would fall out of balance.

That is a very unfortunate situation, but that is the situation that we have dealt with every 10 or 15 years over the history of the program. That is a very different situation than the situation of—and by the way, while the Social Security trust fund would, in our plan, be invested only 15 percent in equities, if the person in your office's pension fund was like the typical private sector pension fund, that fund would be invested about 60 percent in equities.

Moreover, this is a different situation than the situation you would get into with the kind of individual account proposal that Senator Bunning was speaking of because it does not provide for the kind of long-term smoothing that the use of a defined benefit pension plan approach provides for and if you were unlucky enough to be retiring where you had several bad years in the stock market right at the end, you could see half or more of your retirement benefits go away.

That is not a risk when you have it as part of a collective defined benefit approach.

Senator BAYH. Thank you.

The CHAIRMAN. Senator Collins.

Senator Collins. Thank you very much, Mr. Chairman, first of all, for holding these important hearings.

Mr. Secretary, I am very concerned that, despite your assurances, political agendas would, in fact, influence the investment choices that are made if the Federal Government, rather than individuals, make the investment decisions for the Social Security trust fund.

I base my concerns on experiences that I have had and studies I have undertaken of State retirement boards. You point to the fact that there would be an independent, apolitical board. Well, that is

exactly what many States have and yet, many States have experimented with economically targeted investments or social investments at times with unfortunate results.

Similarly, I believe that if Congress were to pass a resolution directing the board to maintain a tobacco-free investment policy where the index funds in question could not own the stock of tobacco companies, I think Congress might well pass such legislation.

Would the President be prepared to veto legislation establishing a tobacco-free policy for investments made by the Social Security independent board that is handling the investments?

Mr. SUMMERS. The sub-cabinet officials are under very strong instructions, Senator, that they are, under no circumstances, to issue veto threats on behalf of the President with respect to hypothetical legislation, but I cannot imagine that such a proposal is one that, in some context, would be found acceptable by this or future presidents.

I think you raise a very important issue by pointing to the state experience. It is one that has been very troubling to us and one to which we have given a great deal of thought. I would respond by making these points.

First, if you look at the enabling statutes for most of the State and local pension funds which have run into the issues that you have provided for, they make explicit reference to the prospect of economically targeted investments or other such practices. We would not contemplate any such permissive language of any kind in the context of a Social Security investment-enabling statute.

So rather than being prescribed, as it is in the State and local enabling statute case, we would imagine that it would be proscribed in the case of the legislation that we would support.

Second, if you look at the performance of even the poorest of the State and local pension funds with the problems that you have spoken about, you will find that they have, over the last 15 years, very substantially out-performed the government bonds in the Social Security trust fund even with the various problems that you have described.

Third, we would contemplate something that to my knowledge is not present in any of the State and local investment statutes, which is that in addition to an independent board, in addition to a requirement that the independent board use private sector managers, which type of thing is not in some State and local statutes, we would envision a third requirement that those independent managers be instructed to invest only in broad-based indices in the entirety of the index without any discretion.

So this is really total autopilot investing and that is a very different kind of thing than what is common in the State and local pension area where you go to a manager and he has got a hot approach, growth stocks, value stocks, growth stocks, value stocks, new quantitative approach, and by the way, we are politically connected.

I mean, there is a very different kind of thing that is envisioned here by virtue of the way the enabling statute would be written very differently and by virtue of the reliance that would be placed on indexed investing.

We have a kind of precedent for this with the Federal Thrift Savings Plan, which whatever issues it raises, has, over the period that it has been operated, I think everyone would agree, been free of any kind of distortion of this kind, which demonstrates that we have some capacity to operate this.

I might just mention finally that if one takes the approach that some favor, which is to have individual accounts operated in some way by the Federal Government with a limited number of choices, all of these same kinds of political pressures would still come to bear, that the primary basic equity choice should involve some economically targeted investments, that the equity option should limit certain kinds of stocks that are supposed to not engage in politically impermissible activities.

So this concern, which I think is a very real one, is a concern that we have to find the best way to manage, but it is a concern that we equally have to find the best way to manage whether we pursue a collective approach or we pursue a more individual approach.

Senator COLLINS. I guess my answer to that is, I do not mind if individuals have political agendas in choosing their own investments. I think it is entirely different——

Mr. SUMMERS. No, but Senator Collins, if I might, my distinction was, most of the individual account proposals contemplate that there would only be three or four choices. So the political process would shape the choices that were open to individuals and that is how you run into the same kind of issue.

Senator COLLINS. Well, it depends what version you are looking at, but let me quickly get to another issue, following up on questions that the Chairman and Senator Bunning have raised with you, and that is, last year, I distinctly remember hearing the President say that he was going to save all of the surplus for Social Security.

Yet, the Omnibus Appropriations Bill that was passed in the waning days of the Congress contained $21 billion of additional spending from the surplus. We spent $21 billion in 21 days of the fiscal year, the first 21 days in the fiscal year.

Therefore, I guess I need to have a lot more reassurance on how you actually are going to be sure that this year the President does not, and I will say, in collusion with some in Congress, spend an enormous amount of money at the end of the year in an attempt to get a last-minute appropriations bill, because I think the experience of this past year was certainly not reassuring.

Mr. SUMMERS. I think there are a whole set of issues around—it is more of an OMB area than a Treasury area, so I cannot speak with much insight, but I think the whole question of the way in which we handle emergency appropriations is obviously one that we are going to have to think very hard about.

But certainly, I think this just speaks to the importance of finding a framework in which we can get Social Security set so that at the end of this year, we will know what resources are available for other needs and then we can work within that envelope.

What that really speaks to, I think, is the importance of our all moving together to find the right kind of solution to the Social Security problem.

Senator COLLINS. Thank you, Mr. Chairman.

The CHAIRMAN. We will not be able to have a second round because I have to move on. Before I thank you for a final time, and that would be that I hope coming out of this meeting for both sides of the aisle and for you, is that we have an understanding now that as far as the majority party on the hill is concerned, agreeing with the President and agreeing with the minority party that we are going to set aside 62 percent of this money for Social Security.

So as far as that 62 percent is concerned, none of that is going to be whittled away on tax decreases or anything. So I hope that from now on whenever we have hearings, whatever committee they are, whoever comes up from the administration, that we have that common understanding.

Thank you very much, Secretary Summers.

Mr. SUMMERS. I welcome what you have said and thank you very much for this opportunity to testify. I am grateful for it.

The CHAIRMAN. And you have been very patient for a very good turn-out of this committee and I thank all my members for participating so well.

Now to the second and last panel, I am going to introduce people and come to the table as I introduce you. Dr. Rudolph Penner, senior fellow, The Urban Institute, formerly director of the Congressional Budget Office. That was 1983 to 1987. Dr. Penner participated in the National Commission on Retirement Policy and that was sponsored by the Center for Strategic and International Studies.

Next will be Edith Rasell. Dr. Rasell is both a medical doctor and an economist with a Ph.D. from American University. She has published articles in a number of academic journals and is the author of "Paycheck Economics."

Our third witness will be Wendell Primus from the Center of Budget and Policy Priorities. Dr. Primus is Director of Income Security at that center. Prior to his work at the center, he served as an Assistant Secretary in the Department of HHS and he is also a person from my own State of Iowa where he received a Ph.D. degree in economics at Iowa State.

Finally, we will hear from Martha Phillips. Martha is the executive director of The Concord Coalition, 1992 to 1997. She is now a member of the Board of Directors at Concord. Prior to her appointment there, Ms. Phillips was staff director at the Committee on Budget of the House of Representatives. Thank you and we will go in the order that I introduced you. Dr. Penner.

STATEMENT OF RUDOLPH PENNER, SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. PENNER. Mr. Chairman and Members of the committee, thank you for the opportunity to testify. I was asked to comment on the President's Social Security proposals, including the proposal to invest trust fund balances in the stock market, and to comment on the revenue implications of other Social Security options.

It is best to think of the President's program as consisting of five unrelated components. They are, (1), create debt and deposit it in the trust funds; (2), save almost three-quarters of the projected unified budget surpluses; (3), invest some trust fund balances in eq-

uity markets; (4), create a universal savings account; and (5), work for a bipartisan agreement on further reforms.

My complete testimony deals with all the components. Here I will only suggest the first three. The President's Social Security proposal does not change benefits or payroll taxes. Consequently, it does nothing to mitigate the increased economic burden imposed by the system after 2010 when demographic factors cause benefits to soar and the growth of payroll tax receipts decline.

Adding debt to the trust fund does not make it any easier to pay future benefits. When the trust fund experiences a deficit, that will be presented to the Treasury and it will be redeemed either by raising taxes, cutting spending, borrowing from the public, or creating new money. Exactly the same options would have to be considered even if there were no assets in the trust fund.

As for saving the surplus, if we do not have the will to change Social Security benefits or taxes, saving the surplus represents a second best approach to reducing future Social Security and Medicare burdens. It will reduce future interest costs to the Government, thus, making it easier to afford the benefits defined by current law.

Saving the surplus will also enhance future economic growth. Although saving the surplus is beneficial, it is not sufficient to solve the problem. CBO estimates that the surplus would have to be increased immediately by 0.6 percent of the GDP to avoid a long-term debt explosion. Instead of increasing the surplus, the President's proposal reduces it by about 25 percent.

As for investing some of the trust fund balances in equity markets, this is a bad idea. The risks of political interference in the marketplace are high and the gains are less than usually claimed.

Proponents of equity investments say that investment managers could be given political independence by creating a structure similar to that of the independent Federal Reserve Board, but this misses the point. It is not the managers that one worries about, it is the Congress changing laws governing the managers. Passing one law can destroy independence.

Proponents reply that the Congress has not interfered in the conduct of monetary policy; however, it is not the structure of the Federal Reserve that protects it. If the Congress irresponsibly interferes with monetary policy, stock and bond markets will crash. It is this fear that keeps the Fed relatively free of congressional interference.

Turning to revenue options, in my view, the Social Security problem should be resolved entirely by slowing the growth of benefits rather than by increasing payroll taxes or subsidizing the system with general revenues. As difficult as it will be to solve the Social Security problem, it will be much harder to deal with the problems of Medicaid and Medicare.

Consequently, the possibility of a tax increase, which is going to be difficult under the best of circumstances, should be preserved to deal with health programs. Nevertheless, the Chairman asked me to explore revenue options and my complete testimony investigates the possibility of raising the payroll tax and increasing the taxation of benefits.

Payroll taxes can be increased either by raising the rate or raising the base. Raising the payroll tax rate one percentage point—a half a point on employers and the same on employees—could close almost half the actuarial deficit in the Social Security system. Achieving the same actuarial improvement in 1995 would have required that the tax base be increased from $61,200 to over $135,000.

Rate increases affect the lowest income workers, but leave much of the low-income population unscathed because they are out of the labor force due to unemployment, retirement, or other reasons. In 1995, about 3 percent of a tax rate increase would have been borne by taxpayers with adjusted gross incomes less than $10,000. If rate increases were deemed desirable, but the Congress wanted to ease the burden on low-income workers, that could be done by raising the Earned Income Credit.

About one-quarter of the increase would be borne by taxpayers with AGIs between $50,000 and $75,000 and another quarter by those between $75,000 and $200,000. The payroll tax does not become significantly regressive until far above the tax base because so many families gain high income only because both husband and wife work outside the home.

A base increase concentrates the paying on the upper middle class. Taxpayers with AGIs between $100,000 and $200,000 would have borne about one-half of the burden of increasing the base to $135,000 in 1995 if there were no behavioral responses.

However, a base increase would represent a large increase in marginal rates for those affected. There would likely be a behavioral response. People in small businesses have some opportunity to convert earnings into a return on capital and in that way to escape the tax.

More generally, the incentives for tax avoidance and tax evasion would rise and worker effort and saving may be depressed, the former perhaps by earlier retirement.

Consequently, the Congress faces a frequently encountered tradeoff. A rate increase is more burdensome to low-income groups, but probably more efficient economically. But as noted previously, the burden on low-income workers imposed by a rate increase can be countered by increasing the EITC.

It is often said that if benefits were taxed like private pensions, 85 percent of the benefit would be included in the tax base. However, this statement may be obsolete as we have eased the taxation of private pensions over time. If the same philosophy were applied as is now applied to Roth and traditional IRAs, about one-half of the benefit would be included in AGI because one-half of the tax was previously deducted from taxable income.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Penner follows:]

Statement of

Rudolph G. Penner
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On

The President's Social Security Proposals and
Revenue Options for Solving the Problem

Before the

Senate Special Committee on Aging

March 1, 1999

The views expressed in this testimony are those of the author and do not necessarily reflect the views of the trustees and employees of the Urban Institute.

Mr. Chairman and members of the committee, thank you for the opportunity to testify. I was asked to comment on the President's Social Security proposals, including the proposal to invest trust fund balances in the stock market, and to comment on the revenue implications of other Social Security reform options.

The President's Proposals

It is best to think of the President's program consisting of five unrelated components. They are:

1. Create debt and deposit it in the trust funds.
2. Save almost three-quarters of projected unified budget surpluses.
3. Invest some trust fund balances in equity markets.
4. Create Universal Saving Accounts.
5. Work for a bipartisan agreement on further reforms.

Create Debt and Deposit It in the Trust Fund - The President's Social Security proposal does not change benefits or payroll taxes. Consequently, it does nothing to mitigate the increased economic burden imposed by the system after 2010 when the baby boomers are retiring, life expectancy continues to grow, and labor force growth virtually ceases because of massive retirements and a low number of youthful entrants.

Adding debt to the trust fund does not make it any easier to pay future benefits. When the trust fund experiences a deficit, the debt will be presented to the Treasury and it

will be redeemed either by raising taxes, cutting spending, borrowing from the public, or creating new money. Those are the only possibilities. Exactly the same options would have to be considered to finance a Social Security deficit if there were no assets in the trust fund.

The President links his desire to add debt to the trust fund to his goal of saving the projected unified budget surplus. But it is important to understand that the new debt is created with the stroke of a pen and that this accounting maneuver could be accomplished even if we were running a unified deficit. Conversely, the surplus could be saved without adding any debt to the trust fund. The President chooses to equate the amount of debt created to 62 percent of the projected unified surplus[1], but he could, as easily, have equated it to 62 percent of the average temperature in March.

The President's gesture may not have important direct economic effects, but it represents an important philosophical change in the nature of Social Security. It has been assumed traditionally that benefits would be almost entirely financed by the payroll tax. The President's proposal eliminates this discipline by suggesting that the trust fund can receive an infusion of assets from the rest of government any time it gets into financial trouble. As a practical matter, this makes it much more likely that Social Security benefits will be financed by something other than payroll taxes in the future -- other tax increases,

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[1] The recommended allocation to the trust fund actually equals 57 percent of projected surpluses. It is 62 percent of the programmatic allocations made by the President, that is to say, the uses other than the interest costs associated with using the surplus for spending programs.

spending cuts, or borrowing. The program will become more like welfare and less like social insurance.

Save About 75 Percent of the Projected Surplus - If we do not have the will to change Social Security benefits or taxes, saving the surplus represents a second best approach to reducing future Social Security and Medicare burdens. It will reduce future interest costs to the government, thus making it easier to afford the benefits defined by current law. Saving the surplus will also enhance future economic growth. Because initial Social Security benefits are indexed to growth, increased growth has the effect of raising real per capita benefits. Consequently, increased growth does not greatly reduce the burden of Social Security relative to income. However, more growth does help a bit, because once the initial level is set upon retirement, benefits are held constant in real terms.

The relationship between growth and Medicare has not been studied as intensely. Growth will increase the wages of medical personnel and so raise Medicare costs, but nevertheless, I would speculate that the cost growth would rise less than the growth in total incomes.

Although saving the surplus is beneficial, it is not sufficient to solve the problem. CBO estimates that the surplus would have to be increased immediately by 0.6 percent of the GDP to avoid a long-term debt explosion. Instead of increasing the surplus, the

President's proposal reduces it by about 25 percent in order to finance spending increases and individual accounts. That is to say, the surplus will be reduced by roughly 0.5 percent of the GDP over the next few years rather than being increased by 0.6 percent. Consequently, further spending cuts or tax increases will be necessary in the future and the longer we wait, the larger they will have to be.

My preferred approach is to use the surplus to finance the transition to a system of individual accounts. The individual accounts must be designed to make up for a slowdown in the growth of Social Security benefits. This is the approach taken by the National Commission on Retirement Policy (NCRP), co-chaired by Senator Breaux, and on which, I was a member. The basic strategy is to accept some worsening of the fiscal situation in the short run in order to buy a major improvement in the long run.

Invest Some Trust Fund Balances in Equity Markets[2] - Historically, the Social Security trust fund has invested only in government bonds. President Clinton would like it also to invest in corporate stocks. The stocks are expected to yield a higher return than bonds, thus postponing the date at which the trust fund is exhausted by the retirement of the baby boomers. According to his plan, the trust fund would own about four percent of the stock market within fifteen years. Because the stocks are purchased by issuing additional bonds to the public, the government is, in essence, buying the stock on 100 percent margin.

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[2] This section is based on the author's "Nix Social Security's Use of Stock", *Newsday*, February 10, 1999, p. A43.

It is a bad idea. The potential gain is less than is claimed and the risk is high that the Congress would use the equity investments of the trust funds for political purposes.

Proponents of equity investment say that investment managers could be given political independence by creating a structure similar to that of the independent Federal Reserve Board. But this misses the point. It is not the managers that one worries about. It is the Congress. Independence can be destroyed by passing one law. That has happened in states like Texas and California where legislatures have politically interfered in the decisions of state employee pension funds.

Proponents reply that the Congress has not interfered in the conduct of monetary policy. However, it is not the structure of the Federal Reserve that protects it. If the Congress irresponsibly interferes with monetary policy, stock and bond markets will crash. It is this fear that keeps the Fed relatively free of Congressional meddling. In contrast, if Congress wanted to use the trust funds to punish certain corporations, the market would be its ally. If the Congress decreed that the trust funds should no longer buy tobacco stocks, it would do so hoping that tobacco share prices would fall.

Proponents also use the civil service employees' thrift plan as an example of government management of equity investments that is free from political interference. But the thrift plan is fundamentally different from Social Security. Civil servants own the accounts and their pensions depend directly on how much their investments earn. If the

Congress interfered with the investments, civil servants would be justified in raising an enormous fuss.

Social Security benefits are determined by a formula that has no connection to the rate of return on trust fund investments. If Congress interfered in trust-fund stock investments, few people would be affected directly. There would be very little protest. If trust funds earn less than expected because of political interference or because the market performs less well than expected, the Congress can wait decades before cutting benefits or raising payroll taxes.

In fact, if the President's whole Social Security proposal is adopted, the Congress will never have to act to change the structure of the system in response to disappointing returns on stock market investments. Under his plan, the Social Security system is given a huge subsidy from the rest of government. That subsidy can be increased if the trust funds investments are interfered with or perform poorly. As noted above, the President's plan destroys the long-standing tradition that Social Security benefits should be almost entirely financed by payroll taxes.

Not only are the risks high, but the gain from stock market investments is often exaggerated. The government's entry into the stock market will drive up the price of stocks. The fact that the trust fund is buying fewer bonds will mean that more bonds must be sold to the public. This, in turn, will raise interest rates. That could be very costly for

the government. As it refinances the public debt, every one-hundredths of a point increase in the interest rate costs about $300 million per year in the long run.

In addition, if the income of the trust fund is increased by these transactions, the income of the public must go down. As income is moved from the private to the public sector, it is no longer taxed and the loss in tax revenue could be significant. These indirect costs are seldom mentioned when the President's proposal is discussed.

If it is a good idea to invest Social Security money in the stock market, it should be a good idea for the highway trust fund as well. Indeed, the Pentagon can probably figure out ways to buy aircraft carriers out of stock market profits. If a little bit of socialism is a good idea, a lot should be wonderful. But the world has had some experience with that idea. I hope that we have learned something.

Create Universal Saving Accounts - It is difficult to comment on this proposal, because few details have been released on how the accounts would be structured, taxed, and administered. Generally, I favor measures to enhance saving. As a matter of tax policy, I would like to see current restrictions on IRA's, 401k's, etc. relaxed.

However, if accounts are created within a package related to Social Security reform, the main intent is usually that they should replace rather than supplement benefits. That is to say, they should be traded for a slowdown in benefit growth. The individual

accounts should be structured with the goal that the returns on the accounts will approximately make up for lost benefits. If accounts are created specifically to supplement benefits, it would be better to consider them within the context of existing tax-favored accounts, so that we do not end up with yet another type of retirement account with its own set of rules. We have enough already.

Work for a Bipartisan Agreement on Further Reforms - We do not know what the President has in mind. The only description of these reforms is that they should extend the life of the trust fund from 2055 to 2075. This goal could be satisfied by just throwing more debt into the trust fund. It is to be hoped that more substantive changes are intended.

An ideal reform would adjust benefits and or taxes, so that the present value of taxes and benefits are equated in perpetuity. If the system is "fixed" only until 2075, the trustees' 75-year projections one year later will indicate that the system is again in deficit.

Revenue Options

The Social Security problem should be resolved entirely by slowing the growth of benefits rather than by increasing payroll taxes or subsidizing the system with general revenues. As difficult as it will be to solve the Social Security problem, it will be much harder to deal with the problems of Medicare and Medicaid. Consequently, the possibility of a tax increase should be preserved to deal with health programs.

Medicare and Medicaid problems are much larger quantitatively than those of Social Security. The CBO projects that Social Security's share of the GDP will rise 2 percentage points between now and 2050, while Medicare and Medicaid's share will rise by 6 percentage points, assuming that GDP growth is not affected by the large increases in the economic burden imposed by entitlements.

Moreover, much of projected increase in the burden associated with Social Security stems from the fact that each successive cohort of retirees is promised increased real per capita benefits because of the way that the benefit formula is indexed to wages. Simply holding the absolute standard of living of the retired population constant would come close to solving the entire Social Security problem. It should not be as hard as it seems to be. Medicare and Medicaid also provide rising real per capita benefits, because health costs are rising faster than other prices in the economy. But holding real per capita costs constant in the long run will involve rationing benefits, perhaps depriving individuals of new medical technology. This will be extremely difficult emotionally, and therefore, politically.

If it is, nevertheless, decided to solve part of the Social Security problem by raising taxes, there are numerous possibilities since the President has opened the door wide to general revenue financing. Any tax could be increased or a new tax could be invented. I shall, however, confine my remarks to tax issues traditionally related to Social Security.

Payroll tax options - Almost one-half of the actuarial deficit of Social Security could be resolved by raising the tax rate on employers and employees by 0.5 percentage points. Approximately the same revenues could be obtained if the payroll tax base were a bit more than doubled.

Raising the tax rate is obviously less progressive than raising the tax base. However, a relatively small share of the tax increase would be paid by low income taxpayers. When taxpayers have low income, it is often because they are not employed or retired, and therefore, do not pay payroll taxes. If the tax rate had been raised by 0.5 percentage points on both employees and employers in 1995 when the payroll tax base was $61,200,[3] about 3 percent of the tax increase would have been paid by those with adjusted gross incomes less than $10,000. For those with incomes under $5,000, the average tax increase would be less than 50 cents a week. However, this represents a large percentage increase in the payroll plus income tax, because many in this class pay little or no income tax and their income tax burden can be negative because of the earned income tax credit. If it were deemed desirable to reduce the burden of the payroll tax rate increase on low earners, that could be accomplished by increasing the rate of the earned income credit.

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[3] The calculations assume that the employee is burdened by both the employer and employee share of the tax increase.

About one-quarter of the increase would be paid by tax payers with adjusted gross incomes between $50,000 and $75,000. Another quarter would be paid by those between $75,000 and $200,000. It should be noted that the payroll tax is not significantly regressive until far above the payroll tax base, because tax paying units often achieve high incomes only because both husbands and wives are working. For such couples, earnings up to $122,400 could have been subjected to the tax increase in 1995. For those above $200,000, the percentage increase in total payroll plus income taxes is a trivial 0.7 percent compared to an average for all taxpayers of about 3 percent.

Raising the payroll tax base to $135,000 in 1995 would have raised the same revenues as the previously described rate increase and would not have affected anyone earning less than $61,200. Its impact would be concentrated on those with AGIs between $100,000 and $200,000. Assuming no behavioral response, they would have paid about one-half the tax increase.

However, it is likely that a large increase in marginal tax rates on those earning between $61,200 and $135,000 would have provoked a significant behavioral response. A single, self-employed individual earning $75,000 would see his or her marginal rate go from about 33 percent (includes personal income and HI marginal rates) to about 43 percent, not counting any state and local income tax. That might be sufficient to induce a sole proprietorship or partnership to incorporate, so that some earnings could be redefined to be profits or dividends not subject to the payroll tax. A higher rate also makes other

types of tax avoidance more likely and is likely to increase tax evasion. There may also be negative effects on work effort and savings. For example, a person may be induced to retire earlier than would happen otherwise.

Increasing the payroll tax rate does not increase the future entitlement to benefits. Increasing the base would increase future benefits under current rules. However, the replacement rate at higher credited lifetime incomes is so low that the system would still earn a significant long-run "profit" from a base increase. But base increases and rate increases raising the same revenues immediately will have different effects on the actuarial balance in the system. To have the same effect on actuarial balance, the base would have to be increased to something greater than $135,000.

The choice between rate increases and base increases faces the usual trade-off between equity and economic efficiency. Base increases concentrate the pain on the more affluent, but are likely to have negative impacts on tax administration, work effort, and saving. Obviously, it is possible to react to this trade-off by considering various mixtures of rate and base increases.

In examining the distributional characteristics of payroll tax increases, it is important not to think of them in isolation. If the Congress wishes to reform the system, alternative options will also have distributional effects and they should be compared to those resulting from payroll tax options. If there are no changes in law, the current benefit

structure cannot be sustained. When the trust fund runs out of financial resources, it is not allowed to pay more in benefits than can be financed by incoming payroll tax receipts. However, the law is not clear on how benefits should be cut under those circumstances. Perhaps, equal proportional cuts should be assumed, and the distributional effect of various reform options should be compared to that baseline.

Increasing the Taxation of Benefits - Currently, the taxation of Social Security benefits is extremely complicated. The taxpayer must adjust income by adding one-half of Social Security benefits plus tax free interest to adjusted gross income. Fifty cents of Social Security benefits must be added to taxable income for every dollar that the adjusted income exceeds $25,000 for singles and $32,000 for joint returns. Eighty-five cents of benefits must be added to taxable income for every dollar of adjusted income in excess of $34,000 for singles and $44,000 for joint returns.

Aside from being complicated, the phase-in of the taxation of benefits has the effect of significantly increasing the implicit marginal rate paid on extra work and saving. To the extent that the phase-in overlaps with the earnings test that reduces benefits one dollar for every three dollars earned, the work disincentive can be substantial.

The Congress obviously chose this complicated approach, because it wanted to exempt the benefits of less affluent retirees from being taxed. But this seems unfair, because private pension benefits are typically taxed if recipients have any taxable income

at all. Why tax someone with $10,000 in Social Security benefits and a $5,000 private pension differently from someone with $5,000 in Social Security benefits and a $10,000 private pension? This leads many to suggest that Social Security benefits should be taxed "the same as private pensions." This is interpreted to mean that 85 percent of the benefit should be included in taxable income. The other 15 percent is an estimate of the contribution of principal out of after-tax income.

If this was done, it would eliminate about 16 percent of the current actuarial deficit in the system. The distribution tables would not look good, because the burden would fall entirely on the less affluent. But it can be argued that it was unfair to exempt the taxation of their benefits in the first place.

However, all this is predicated on the proposition that it is right to tax 85 percent of benefits. It once was the treatment afforded typical private pensions, but that time is long past. Current tax law recognizes a bewildering array of retirement vehicles that are now afforded special tax treatment. In traditional IRAs and 401ks, deposits up to different limits are deductible, but the entire amount is taxable when funds are withdrawn from the accounts. In the relatively new Roth IRA, deposits into the accounts are not deductible, but withdrawals are not taxed.

If the same theory were applied to Social Security, benefits financed by tax deductible payroll taxes (the employer share) would be fully taxed while benefits financed

by non-deductible payroll taxes would be tax free. That is to say, one-half of benefits would be included in everyone's adjusted gross income. I do not have an estimate as to whether revenues would go up or down under this approach, but it is unlikely that they would change significantly in either direction as the taxes of the most affluent would be cut a bit whereas those of the less affluent would be raised. If the distributional effects of this approach seem unappealing, the less affluent can be given relief by raising the extra exemption given people over 65. On the other hand, some would question the tax relief already given seniors compared to that given younger people.

Other Proposals - Although much of this testimony has been about increasing taxes, a number of reform proposals would cut the tax burden. The Gregg-Breaux-Kolbe-Stenholm proposal would cut the payroll tax by two percentage points in order to ease the transition to a system of individual accounts. Senator Gramm would cut the payroll tax three percentage points, but compensate the trust funds out of general revenues. Senators Moynihan and Kerrey would also cut the payroll tax, but because they think that it would be more honest to put Social Security on a true pay-as-you-go basis. They would raise the tax in the future as needed. All these plans have provisions that reduce benefit growth. As noted previously, plans that use some of the surplus in this manner in the short-run are worthwhile if they result in a better fiscal situation in the long run. There is always the danger that the first part of the deal is accepted, and the second part is abandoned once it becomes painful. This danger is lessened if the painful part of the deal is clearly defined and well understood before the reform is implemented.

Conclusions

The President's plan to add debt to the trust fund is unfortunate. It does nothing to reduce the real burden of paying future Social Security benefits, but it probably reduces the prospects for true reform by creating the illusion that something real has been done. The proposal to invest some of the trust fund in the stock market is equally undesirable. It creates a large risk of political interference in the market place and the financial gain to the trust fund is offset by a higher interest bill and lower tax revenues in the rest of government.

I do not favor using tax increases to solve the Social Security problem. Medicare and Medicaid problems are larger quantitatively and more difficult to solve. I would preserve any capacity to raise taxes -- and it is small under the best of conditions -- to deal with that more difficult problem.

If payroll taxes are to be raised, both tax base and tax rate increases can be considered. A very large base increase is necessary to raise the same amount of revenue as a relatively small rate increase. To the extent the base is increased, the pain is concentrated on more affluent taxpayers, but the significant increase in the marginal tax rate facing the upper middle class is likely to reduce economic efficiency and create problems for tax administration. A rate increase pains everyone with earnings including

those at the bottom of the income scale. This effect can, however, be mitigated by increasing the earned income credit.

Taxing benefits more heavily can at best solve only a small part of the Social Security problem. The argument for taxing benefits more heavily was stronger before the tax system began to favor various types of private retirement accounts. If Social Security were treated the way that traditional and Roth IRAs are treated, one-half of benefits would be included in AGI.

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The CHAIRMAN. Thank you, Dr. Penner. Dr. Rasell.

STATEMENT OF EDITH RASELL, ECONOMIST, ECONOMIC POLICY INSTITUTE, WASHINGTON, DC

Dr. RASELL. Mr. Chairman and members of the committee, good afternoon. I am Edith Rasell, an economist at the Economic Policy Institute. Thank you for the opportunity to testify. I am going to briefly summarize my remarks and then begin by examining the revenue options that you requested us to discuss.

To strengthen Social Security, the Nation should devote a large portion of the Federal budget surplus to the trust fund. We must also raise the cap on earnings subject to the Social Security payroll tax. Eventually, we will also need to raise the payroll tax rate.

More fundamentally, we must increase the level of public investment since strengthening the economy will better equip the Nation to meet its obligations in the future. Now I want to address the five revenue options that you asked us to look at.

First regarding the taxable wage base, this should be increased to include a larger share of earnings. Currently Social Security payroll taxes are levied on earnings up to $72,600 only. The cap on earnings is raised each year at the rate of the growth in average earnings.

However, since over the past 20 years wages and salaries at the top of the earnings distribution have been growing faster than in the middle or the bottom, a growing share of all earnings exceeds the cap.

In the early 1980's, fully 90 percent of all earnings were subject to the Social Security payroll tax. Now the share is about 87 percent and the trustees project that it will fall further to 85.7 percent. At a minimum, we should raise the cap and maintain it at a level to include 90 percent of earnings while raising benefits accordingly.

This would put the cap roughly at about $110,000 per year. This would close the 75-year shortfall by about one-quarter of the total. This is the minimum amounts that I would argue the cap should be raised.

It would also be appropriate to tax all earnings as does the Medicare payroll tax now and this would close about three-quarters of the shortfall. Raising the cap would increase revenues for Social Security and also make the payroll tax less regressive.

Now turning to the payroll tax rate, eventually this will have to be raised as well, although for the time being, we can increase revenues into the trust fund by using money from the Federal budget surplus. It makes sense to raise the rate since two-thirds of the projected funding shortfall is due to people living longer.

If people live longer and spend more years in retirement receiving Social Security, it is reasonable that they would pay more into the system. One way to think about raising the tax is to index it to longevity.

For example, we could increase the tax rate by 0.02 percentage points each year applied to both the employer and the employee shares of the tax. This would mean that after 1 year, the payroll tax would rise from 6.2 percent to 6.22 percent. After 10 years, it

would reach 6.4 percent of payroll. After 50 years, it would be at 7.2. So you can see these are very small increases.

During this time when the payroll tax rate would rise at 0.02 percentage points a year, wages would be rising by about 1 percent a year as the trustees project. So wages would be rising about 50 times faster than this increase in the payroll tax. However, this small tax increase would close about two-thirds of the funding shortfall over the 75-year period.

Regarding the third option, taxing benefits more like private pension income, I would argue that we should avoid doing this because this tax increase would fall most heavily on low and moderate-income beneficiaries. Social Security redistributes income from high earners to low and moderate ones.

It is these low and moderate-income beneficiaries who receive the largest benefits relative to their contributions. Consequently, if Social Security were taxed like private pensions where people pay taxes on all benefits that exceed their contributions, then low and moderate-income beneficiaries would be taxed on a larger share of their contributions—I'm sorry—on a larger share of their benefits than would higher income beneficiaries.

This new tax liability would increase taxes for the low and moderate-income beneficiaries while taxes for higher income beneficiaries fell. The 85 percent rule should be retained with the tax exclusion for the benefits received by single people with incomes below $25,000 and couples below $32,000 retained.

We were also asked whether revenue from taxing benefits that currently goes to the Medicare trust fund should continue to go there. I would argue that it should. The shortfall in the Medicare trust fund, which is 2.1 percent of payroll, is about the same size as the shortfall in the Social Security trust fund and the revenue increases needed for Part B of Medicare are even larger. So we should not be shifting money from Medicare to Social Security.

I now turn to President Clinton's proposal to spend 62 percent of the 15-year surplus for Social Security. The trust fund needs additional revenue and Federal revenues exceed budgeted expenditures. Therefore, it makes sense that part of the surplus be used to increase the trust fund balance.

I will not get into it, but the charge of double-counting is nonsense. We have always spent the Social Security surpluses and what the President has proposed is no change from past practices.

However, given the nation's other pressing needs, spending 62 percent of the surplus on Social Security is too much. There are too many other things that need to be done. The Medicare program is going to need more than 15 percent of the surplus. The nation has many other unmet needs as well, and we also need to spend more on public investment, public investments that will build a strong economy in the future so that we can more easily pay the costs of Social Security and Medicare.

One possible way to use the surplus would be to spend about a third on Social Security, a third on Medicare, and a third on other needs. Buying equities through the trust fund is a bad idea, but not because of the potential for government influence over the behavior of firms. I think this could be avoided by buying equities through these broad index funds, as has been discussed.

But a more fundamental problem with this proposal is that once Social Security owned a couple hundred billion dollars in equities, these investments could foster in policymakers a concern with the stock market that might override other, more important goals of economic policy such as lowering the unemployment rate. So the concern is with what this investment would do to public policy decisions, not with effects on individual firms.

In concluding, I want to briefly look at the big picture. When the debt held by the trust fund comes due, the Nation will have two options for coming up with the cash, raising taxes or we could also cut other spending. At that time, the larger and more fast growing the economy, the better able the Nation will be to meet these obligations without excessive borrowing.

Right now, the Federal Government should be doing everything possible to strengthen the future economy so that workers will have higher incomes and be able to pay higher taxes while still enjoying a higher standard of living. To achieve this goal, we should be making large public and private investments.

Private investment has been growing in recent years, but public investment, measured as a share of GDP, is one to one-and-a-half percentage points below the level of the 1980's and the early 1990's according to the OMB. It is over 3 percentage points below the level of the 1960's.

Over the next 5 years, public investment is projected to remain at this very small, but a fairly constant level, neither rising nor declining. To strengthen the future economy, we should increase public investment. In a growing economy with broad-based wage growth, taxes can rise while living standards also climb. We need to do everything we can today to ensure that this is the future. Thank you.

[The prepared statement of Dr. Rasell follows:]

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Funding the Social Security Program
by
M. Edith Rasell, M.D., Ph.D.

Testimony before the Special Committee on Aging, U.S. Senate
Hearing on "Social Security Reform: Is More Money the Answer?"

March 1, 1999

Dirksen Senate Office Building
Room 628

Good morning. I am Edith Rasell, an economist at the Economic Policy Institute. Thank you for the opportunity to testify about additional revenue sources for Social Security. I will briefly summarize my remarks then begin by examining the five options you requested us to discuss.

To strengthen Social Security, the nation should devote a large portion of the federal budget surplus to the Social Security trust fund. We must also raise the cap on earnings subject to the Social Security payroll tax. Eventually we will also need to raise the payroll tax rate. More fundamentally, we must raise the level of public investment. This will strengthen the future economy and better equip the nation to meet its obligations.

Options for Additional Revenue

Increase the taxable wage base: To increase revenue for Social Security and reduce the regressivity of the payroll tax, the taxable wage base should be expanded to include a larger share of earnings.

Currently, Social Security payroll taxes are levied on earnings up to $72,600 only. The cap on earnings is raised each year at the rate of growth in average earnings. However, over the past 20 years, wages and salaries at the top of the earnings distribution have been growing faster than in the middle or the bottom. As a result, a growing share of all earnings exceed the cap. Raising the cap on earnings would increase revenue for Social Security and make the payroll tax less regressive.

In the early 1980s, fully 90% of earnings were subject to the Social Security payroll tax. Now the share is about 87% and the Trustees project it will fall further to 85.7%. Raising the cap and maintaining it at a level to include 90% of earnings (while also raising benefits accordingly) would close the Social Security 75-year projected shortfall by about 0.55 percentage points, or one-quarter of the total. This is the minimum amount by which the taxable wage base should be increased. It would also be appropriate to tax all earnings, as the Medicare payroll tax does, (this would close about three-quarters of the shortfall), and extend the Social Security tax to unearned income.

Increase payroll taxes: The Social Security program will need additional funds in the future. For the time being, a part of the federal budget surplus can and should be earmarked for the trust fund and a tax increase can be delayed. But, ultimately, we will probably need to raise the tax rate.

Since two-thirds of the projected funding shortfall is due to people living longer, an appropriate way to raise the tax rate is to index it to longevity. For example, we could increase the tax rate by 0.02 percentage points each year, applied to both the employer and employee shares of the tax. After one year, the payroll tax would be 6.22%; after 10 years, it would have increased to 6.4%. It would take 50 years to rise a full percentage point to 7.2%. (While taxes were rising by 0.02 percentage points each year, the Trustees project real wages will grow 0.9%

to 1.1% each year, about 50 times faster.) This small tax increase would eliminate about two-thirds of the funding shortfall over the next 75 years.

Taxing benefits more like private pension income: In private pension plans, benefits received by each individual in excess of their contributions are subject to taxation. It has been proposed that this practice be extended to Social Security, replacing the current policy of taxing 85% of benefits.

If this proposal were adopted, low- and moderate-income beneficiaries would see the largest increase in taxes. Social Security redistributes income from high-earners to low and moderate ones. It is these low- and moderate-income beneficiaries who receive the largest benefits *relative to their contributions.* Consequently, under this proposal they would be taxed on a larger share of their benefits than higher-income beneficiaries. Their tax liability would likely increase while that of higher income beneficiaries fell. The 85% rule should be retained along with the tax exclusion for benefits received by single people with incomes below $25,000 and couples below $32,000.

Recapture revenue now devoted to the Hospital Insurance trust fund for the Social Security trust fund: The shortfall in the Medicare HI trust fund (2.1% of payroll) is roughly the same size as the Social Security trust fund shortfall and the revenue increases needed for Part B are even larger. We should not shift money from Medicare to Social Security.

Decrease the payroll tax: Since the system is inadequately funded over the long term, this would be a move in the wrong direction.

President Clinton's Social Security Proposal

Spending 62% of the 15-Year Surplus for Social Security: The President proposes paying the trust fund fully 62% of the federal budget surplus over the next 15 years, a total of $2.7 trillion. The trust fund needs additional revenue and federal revenues exceed budgeted expenses. Therefore, part of the surplus could and should be used to increase the trust fund balance.

However, given the nation's other pressing needs, 62% is probably too much. As mentioned, the Medicare program including both Parts A and B has a long-term funding deficit that is larger than Social Security's. The President's proposal to devote 15% of the surplus to Medicare is entirely inadequate. The nation also needs to be making the public investments now that will build a strong economy in the future so that we can more easily pay the costs of Social Security and Medicare. Some of the surplus should be explicitly devoted to increase public investment.

Some critics have labeled the President's plan for Social Security double counting or sleight of hand. But what is being proposed withstands rigorous scrutiny. Much of the future federal budget surplus (and all of it in FY2000) comes from the Social Security trust fund. By

law, the trust fund must buy U.S. treasury bonds with the excess. The sale of these bonds by the treasury to the trust fund generates revenue for the treasury (just as does the sale of bonds to private investors) that can be used to pay for education, Medicare, the military, and all the other things purchased by the federal government. The President is proposing that some of this money be devoted to Social Security, that is, be given to the trust fund. When this happens, since Social Security will not need to spend the money now, the trust fund will use it to purchase treasury bonds and the money will flow back to the treasury. But the federal budget presents no plan for spending this money. On the contrary, it is earmarked for reducing the debt held by the public. In short, publicly-held debt will be replaced, dollar for dollar, by debt held by the trust fund. Although complicated, there is no double counting and nothing that differs from past practices. The nation is reducing the federal debt today with the expectation that when money is needed in the future to pay off the bonds held by the trust fund (or by private investors), we will have the option of borrowing as well as raising taxes.

Buying Equities: President Clinton also proposes buying equities with some of the money in the trust fund -- a policy that should be opposed. Government stock market investments pose special problems. The one that has received the most attention is the possibility that the federal government in its role as shareholder could try to influence the behavior of firms. However, the President proposes that the equity investments be made exclusively in broad-based index funds like the Wilshire 5000. This would probably preclude the possibility that the government could exert influence on firm behavior through its role as shareholder.

A more fundamental problem with this proposal is that these investments could foster in policy makers a concern with stock market performance that might supercede a broader goal of economic policy: to promote healthy and sustainable economic growth that benefits all Americans. It is for this reason that the trust fund should not invest in equities.

Over-stated Stock Market Returns: Both the President's proposal that the trust fund purchase equities and proposals for individual accounts that would permit workers to invest some or all of their Social Security payroll taxes in the stock market share a common flaw. They greatly overestimate the returns that will be received in the stock market in the future. Most analysts assume that the inflation-adjusted, average, annual rate of return on stocks over the next 75 years will equal the rate of the past 75 years, 7.0%. (The President's budget assumed a return of 6.75%.) But if economic growth over the next 75 years averages half the rate of the past 75 years, as projected by the Trustees, then returns on stock will average only about 4.0%, not 7%.[1] Moreover, in individual accounts, transaction and brokerage fees will absorb 1% to 2% of the value of the account each year, leaving an actual return of 2% to 3%. In comparison, the Trustees project treasury bonds will pay about 2.8% on average. There will be little advantage to the average individual account holder from investing in equities. Equity investments by the trust fund could potentially bring a higher return than treasury bonds since fees will be much lower. However, the small difference is probably not worth the risks that would be incurred.

Social Insurance, not an Investment

There has been much interest in the estimated internal rate of return of the Social Security program compared with various reform proposals. But these calculations do not accurately reflect Social Security's value to workers which is more than the monetary benefits received. Social Security is a social insurance program, not an investment plan. It provides a real-valued annuity to retirees — that is, retirees receive an annual payment, adjusted each year for inflation, that will continue throughout their lifetimes. Such an insurance product is rarely available in the private market. Moreover, the annuity provided by Social Security automatically covers dependent spouses after the death of the primary beneficiary. Social Security also provides disability insurance and benefits to survivors of deceased workers. To see Social Security solely in terms of the monetary benefits received is to grossly understate its value.

Meeting Obligations in the Long Term

Before concluding, I want to briefly look at the big picture. Federal government debt increased over the 1980s and early 1990s. If the Social Security trust fund had not loaned money to the U.S. treasury, borrowing from the public would have been greater. But total debt, including both public and private, would have been unchanged. As this debt comes due, the nation will have two options for coming up with the cash: raising taxes or borrowing. The larger and more fast growing the economy, the better able the nation will be to meet these obligations without borrowing. At this time, the federal government should be doing everything possible to strengthen the future economy so that workers will have higher incomes and be able to pay higher taxes while still enjoying a rising standard of living. To achieve this goal, we should be making large public and private investments. Private investment has grown in recent years. But public investment measured as a share of GDP — including expenditures for education and training, infrastructure, and research and development — is 1 to 1½ percentage points below the level of the 1980s and early 1990s according to the Office of Management and Budget. It is over 3 percentage points below the level of the 1960s. Over the next five years, public investment will remain a fairly constant but small share of GDP. To strengthen the future economy, we should increase public investment. In a growing economy with broad-based wage growth, taxes can rise while living standards also climb. We need to do everything we can today to ensure that this will be our future.

Endnote

1. This assumes that dividends as a share of stock price remain at their current level of about 2.5% and that stock prices which track dividends which, in turn, track corporate profits which, over the long run, must track economic growth will rise by 1.5% annually, the Social Security Trustees' projection for economic growth over the next 75 years. (See Dean Baker, *Saving Social Security with Stocks: The Promises Don't Add Up*, Washington DC: Twentieth Century Fund/Economic Policy Institute, 1997.)

The CHAIRMAN. Thank you, Dr. Rasell. Dr. Primus.

STATEMENT OF WENDELL PRIMUS, DIRECTOR, INCOME SECURITY, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Dr. PRIMUS. Mr. Chairman and Members of the committee, I very much appreciate your invitation to testify on the subject of revenue options for financing Social Security. Any bipartisan solution that would restore solvency to Social Security over the next 75 years and restore confidence in the program is likely to involve increased revenues to the system.

I would note at the outset that the current payroll tax is a fixed rate for the next 75 years. In light of increasing longevity, the increasing percentage of the population that is over age 65, and the decreasing amount of total compensation received as cash wages, it is unrealistic to expect that the amount of payroll tax revenues needed to finance Social Security should decline as a percentage of gross domestic product.

But that is exactly what occurs under current law, about a 0.7 percentage point decline. That decline would be worth about $64 billion a year in today's dollars. Let me hasten to add that I also believe a bipartisan solution must necessarily involve some benefit reductions.

I would also note that all of the major Social Security proposals currently being considered in Congress involve additional revenues of some kind. Let me begin by discussing one option that almost everyone agrees about. Every policymaker would like to achieve a greater rate of return on investments. Doing so lessens the degree to which painful tax increases or benefit reductions may be needed.

The administration has submitted a thoughtful and well-designed proposal on this matter. The proposal would remove management of a portion of the trust fund reserves from the executive branch and Congress and transfer it to an independent, non-political professional management board structured so that the board would be beyond administration and congressional control.

Many critics would have you believe that investing the Social Security trust funds as the President has suggested is terrible policy, but having funds invested in equities through individual accounts is wonderful policy. The National Commission on Retirement Policy is one well-thought out approach that allows individuals to invest a portion of their individual accounts in equities.

This legislation, introduced by Senators Breaux and Gregg, would create individual accounts which would be administered centrally with the funds in these accounts invested by a board or institution managed by Federal appointees.

The board would select private fund managers who would do the actual investment of the funds. Its role and function would be virtually identical to those of the board the administration has proposed. In neither case does the Government do the investing.

If the Breaux-Gregg proposal protects the investment from political interference, so should the administration's proposal since both plans use identical structures to do the investing.

A strong case can be made for general revenue contributions to Social Security. I think that is the major issue. Under current law, several types have already been authorized.

Besides these already-authorized transfers, there are at least two other reasons that support use of general revenue contributions: Compensating Social Security on a one-time temporary basis for benefit payments well in excess of payroll contributions made for the first several generations of Social Security beneficiaries; and compensating Social Security for lost earnings to the extent that certain restrictions continue on where Social Security may invest its monies.

Let me just deal with that last reason. Workers currently paying Social Security payroll taxes should not be penalized by having all of their pension fund balances invested only in Treasury securities. The restriction barring the trust funds from investing in anything other than Treasury bonds is understandable given the history and origins of the program which was established in the 1930's not long after the stock market crash of 1929.

But this restriction does not continue to make sense today. To the extent that policymakers are not willing to invest up to 50 percent of the trust fund reserve in equities, there is a strong case for a general revenue transfer to compensate the trust fund for this lost income.

This leads me to the strongest economic feature of the administration's proposal, the reduction in the amount of public debt outstanding. The projected surpluses present you with once-in-a-generation choice. You can either spend those surpluses by cutting taxes or raising government spending and thus boosting current consumption, or you can save those surpluses by strengthening Social Security and Medicare, paying down the debt held by the public, raising national savings investment in economic growth.

I believe the American public would much rather have you save the surplus and strengthen Social Security and Medicare. To the extent that Congress saves the on-budget surplus and reduces the public debt, it is entirely appropriate to credit the Medicare and Social Security trust funds with those savings.

Having said this, I do have concerns with aspects of the administration's proposals for transfers to the Social Security trust fund. If not tied to structural reforms in Social Security, the up-front crediting of $2.8 trillion over the next 15 years might encourage policymakers to avoid needed structural changes in Social Security, i.e., reduction in benefits or increases in revenues.

Indeed, the crediting the administration has proposed, coupling with a higher level of trust fund investment in equities, could make the Social Security program completely solvent over 75 years without any structural changes.

In addition, transferring large amounts of general revenue without making clear the policy basis for the transfer and without tying the transfer more tightly to that policy basis for it could reduce public confidence in the program. Transfers from general revenues need to be limited, rather than open-ended, and need to have a clear policy basis.

I would, therefore, suggest that the Congress consider the following guidelines for general fund transfers. Transfers to Social Secu-

rity or Medicare from on-budget surpluses, which would result in further reductions in publicly held debt.

In addition to these transfers, further transfers are appropriate to the extent that Congress is unwilling to grant the authority to invest up to 50 percent of the reserves in equities. An explicit linkage of these transfers to other structural changes should be considered.

In addition, if Medicare is given sufficient transfers from on-budget surpluses, transferring back from the Medicare trust fund to Social Security, the Social Security-related revenue is probably appropriate.

Finally, it is extremely important that all of the Social Security surpluses be walled off in a manner that precludes their being used for tax reductions or spending increases. In the first several years, Mr. Chairman, this may be a different percentage than 62 percent. It could be considerably more.

I think in addition, the pay-as-you-go rule should continue to apply until Social Security is solvent, and after that date, you may want to modify it so it can use on-budget transfers. But I think it is very important that this rule be continued.

Contrast these suggestions to some of the approaches being considered in Congress. I have serious reservations about approaches that would use on-budget surpluses to provide tax cuts and use a large portion of the Social Security surpluses to establish individual accounts.

These plans will not reduce the publicly held debt very much, forcing Americans to pay higher interest bills than under a plan that does largely reduce or eliminate the publicly held debt. The Feldstein approach, I think, is an example of one where you are actually increasing.

I think the last thing you ought to do—and this is my "in conclusion," Mr. Chairman. The last thing you ought to do right now is increase the promises to the elderly generation, and that is what would happen under the Feldstein approach.

I think you should first try to fund the promises that have already been made under Social Security and Medicare and not increase those promises.

[The prepared statement of Dr. Primus follows:]

TESTIMONY OF WENDELL PRIMUS
Director of Income Security, Center on Budget and Policy Priorities
before the Senate Special Committee on Aging
March 1, 1999

Mr. Chairman and Members of the Committee on Aging:

I very much appreciate your invitation to testify on the subject of revenue options for financing Social Security. My name is Wendell Primus and I am Director of Income Security at the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy organization that conducts research and analysis on a wide range of issues affecting low- and moderate-income families. We are primarily funded by foundations and receive no federal funding.

INTRODUCTION

Any bipartisan solution that would restore solvency to Social Security over the next 75 years and restore confidence in the program, especially among our younger generations, is likely to involve increased revenues to the system. I would note at the outset that the current payroll tax is a fixed rate for the entire 75 year period. In light of increasing longevity, the increasing percentage of the population that is over age 65 and the decreasing amount of total compensation received as cash wages, it is unrealistic to expect that the amount of payroll tax revenues over this entire period to finance Social Security should decline as a percentage of GDP. But that is exactly what occurs under current law — about a 0.7 percentage point decline. That decline would be worth about $64 billion a year in today's dollars. Let me hasten to add that I also believe a bipartisan solution must necessarily involve some benefit reductions.

In your letter of invitation, you suggest that the hearing address four different types of revenue increases. The first type of revenue enhancement I will discuss is the Administration's proposal to obtain a higher rate of return through investment of a portion of the fund in equities. The second is the related proposal to increase general revenue financing of Social Security. The third is increases in the Social Security wage base or the payroll tax rate and the fourth is increased taxation of Social Security benefits. (While increasing revenues to the trust fund, this fourth proposal is in reality a progressive benefit cut.) To these types, I would add one more which I will discuss briefly– Social Security coverage of newly hired state and local workers.

I also would note that all of the major Social Security proposals currently being considered in Congress involve additional revenues of some kind. The President's

proposal clearly involves significant new financing from general revenues. Based on papers authored by Senator Gramm, his approach also involves a significant amount of general revenues. The Breaux-Gregg bill provides for coverage of newly hired state and local employees not now covered by Social Security. If a bipartisan solution is to be found, it will involve revenues.

INCREASING THE RATE OF RETURN

Let me begin by discussing one option that almost everyone agrees about. Every policy maker would like to achieve a greater rate of return on investments. Doing so lessens the degree to which painful tax increases or benefit reductions may be needed. The difference is that some plans advocate investment of the Social Security trust funds themselves, like the President's approach, while other plans advocate investment in equities through individual accounts.

President Clinton has proposed investing about 15 percent of the Social Security reserves in the equities markets. Over the next 15 years, approximately $600 billion of budget surpluses would be invested in this manner on behalf of Social Security. The Center recently released a detailed analysis of the proposal which I will submit for the record.

The Administration has submitted a thoughtful and well-designed proposal on this matter. The proposal would remove management of a portion of the trust-fund reserves from the executive branch and Congress and transfer it to an independent, non-political, professional management board structured so the board would be beyond Administration and Congressional control. This independent board, the members of which would be expected to have substantial experience in pensions and investing, would in turn contract with private fund managers selected through competitive bidding. These managers — which would include entities such as Merrill Lynch, Vanguard, or State Street Bank — would do the investing of a modest portion of Social Security reserves in broad index funds in the equities markets.

To ensure the independence of the professional management board that would select the private fund managers, the board would be structured like the Federal Reserve Board or the Federal Retirement Thrift Investment Board, the entity that oversees the investment of the funds that federal employees deposit through the Thrift Savings Plan.

Since its creation in 1986, the Federal Retirement Thrift Investment Board has maintained its independence and not been subject to political meddling. As Francis X. Cavanaugh, the Board's first executive director, has noted, Congress designed the

board to be insulated from both political interference and corporate decision-making, and this design has worked.[1]

The Federal Retirement Thrift Investment Board also provides a model for how the Administration's proposal would work in another way. Equity investment by the Thrift Investment Board is limited to a stock index fund; the Board does not pick and choose among companies or sectors of the economy. The same would be true under the Administration's proposal. Equity investment would be limited to passive investment in very broad index funds, with neither the independent board nor the private-fund managers having authority to add or delete companies from the indices.
The Administration's proposal is quite cautious in this regard, involving very modest holding of equities. When the proposal was fully in effect, 14.6 percent of Social Security reserves — about one dollar in every seven in the reserves — would be invested in equities. By contrast, state and local public employee pension funds invest more than 60 percent of their assets in equities. The Federal Reserve System's defined-benefit pension plan invests 65 of its assets in equities. Therefore, I support the Administration's approach. I believe sound policy would allow up to 50 percent of Social Security's trust funds to be invested in equities.

Many critics would have you believe that investing the Social Security trust funds as the President has suggested is terrible policy but having funds invested in equities through individual accounts is wonderful policy. The National Commission on Retirement Policy (NCRP) plan is one well-thought out approach that allows individuals to invest a portion of their individual accounts in equities. The individual accounts that the legislation introduced by Senators Gregg and Breaux and Representatives Kolbe and Stenholm would create would be administered centrally, with the funds in these accounts invested by a board or institution managed by federal appointees. The board would select private fund managers who would do the actual investment of the funds. *Its role and function would be virtually identical to those of the board the Administration has proposed.* In neither case does government do the investing. If the NCRP proposal protects the investment from political interference, so should the Administration's proposal since both plans use identical structures to do the investing.

GENERAL REVENUES

A strong case can be made for general revenue contributions to Social Security. Under current law, several types of general revenue contributions to Social Security have already been authorized. These are (1) contributions made by the Federal government

[1]See "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p.16.

as employer, (2) funds from general revenues to reflect the taxation of Social Security benefits, and (3) a small amount of general revenue contributions to cover the cost of the Prouty amendment.

Besides these already-authorized general revenue transfers, there are two other reasons that support use of general revenue contributions:

1. Compensating Social Security on a one-time, temporary basis for benefit payments well in excess of payroll contributions made for the first several generations of Social Security beneficiaries.

2. Compensating Social Security for lost earnings to the extent that certain restrictions continue on where Social Security may invest its monies.

In Social Security's early years, its designers faced a difficult question —should those already retired or nearing retirement age be able to receive benefits? Since the program was in its infancy, these individuals contributed little or nothing to Social Security during their working years. But many of them, including workers who had endured the Depression and fought for the nation in World War I, would otherwise face poverty in old age.

Policymakers of that era made the humane decision; they decided to provide, rather than deny, Social Security to these individuals. That decision meant Social Security would primarily be a pay-as-you-go system, with current payroll tax revenues used to fund the benefits of current retirees, rather than a pre-funded system. The establishment of Social Security largely as a pay-as-you-go system also meant that when a demographically large generation retired, such as the baby boom generation, financial pressures on the pay-as-you-go system would intensify.

The decision made 60 years ago to provide benefits to retirees of that era who had not paid much into the Social Security system provides a strong justification for a temporary general fund infusion revenue into Social Security today. It makes sense to "reimburse" the Social Security system today in some form for a limited period of time for bearing the costs of providing benefits to earlier generations of beneficiaries who had paid little into the system because the system was new.

Compensating Social Security for Lost Earnings

Social Security surpluses are now adding substantially to national saving. Because Social Security is able to purchase so many Treasury bonds, other investors can hold fewer bonds and invest more money in equities, securing the higher average rates of return that equities provide over the long term. Robert Reischauer and Henry Aaron of the Brookings Institution, among others, have suggested that because Social Security is

adding to national saving in this manner, the trust fund should be able to receive its fair share of the higher rate of return that equities generate. They propose this be done by diversifying the trust fund's investments and ultimately placing up to half of trust fund reserves in equities. This is roughly the same share of reserves as are placed in equities by corporate pension plans and state and local public employee pension funds. The Administration's proposal is much more cautious, placing about 15 percent of trust fund reserves in equities.

Workers currently paying Social Security payroll taxes should not be penalized by having all of their pension fund balances invested only in Treasury securities. The restriction barring the trust funds from investing in anything other than Treasury bonds is understandable, given the history and origins of the program, which was established in the 1930's not long after the stock market crash of 1929. But this restriction does not continue to make sense today.

To the extent that policymakers are not willing to invest up to 50 percent of trust fund reserves in equities, there is a strong case for a general revenue transfer to compensate the trust fund for the lost income. To the extent that Social Security is confined to lower returns by being restricted to investments in lower-yielding Treasury bonds — and private investors are able to secure higher returns because they can purchase fewer Treasury bonds and thus have more resources to place in equities — general revenue collections will be higher. These collections will be higher because investors will pay taxes on the higher returns that they are able to secure because Social Security is using its reserves to add to national saving and pay down publicly held debt. A strong case can be made for transferring a portion of these added general revenues to Social Security.

That leads me to the strongest economic feature of the Administration's proposal — the reduction in the amount of the public debt outstanding. The Administration projects unified budget surpluses of $4.85 trillion over the next 15 years. Under the Administration's plan, $2.87 trillion of these surpluses would be used to reduce the public debt, about $580 billion would be invested in equities and about $1.4 trillion would be spent. The interest savings alone from this proposal (as a percentage of GDP) would more than offset the increase in Social Security benefits over the first half of the next century.

This can best be illustrated in the following way. Over the last 10 years, the combined amount that we have spent on Social Security and net interest costs has averaged 7.7 percent of GDP. If we could reduce our net interest costs to zero and maintain them there, our combined Social Security and interest expenditures as a percent of GDP (and hence the burden that these expenditures will place on future generations) will not exceed the 7.7 percent level until about 2070 under the actuaries' intermediate assumptions. This proposal also would increase national saving and thus, over time, probably lead to somewhat higher levels of GDP.

Once-in-a-Generation Choice

The projected surpluses present policymakers with a once-in-a-generation choice. You can either spend those surpluses by cutting taxes or raising government spending and thus boosting current consumption. Or you can save those surpluses by strengthening Social Security and Medicare, paying down the debt held by the public, and raising national saving, investment and economic growth.

I believe the American public would much rather have you save the surplus and strengthen Social Security and Medicare. The Administration has proposed setting aside 35 percent of the on-budget surpluses to strengthen Medicare and Social Security over the next 15 years. The President has proposed crediting the Hospital Insurance Trust (Medicare) fund with 14 percent of the total surplus (and about a third of the on-budget surplus), which would result in Medicare holding $686 billion of additional Treasury securities and the public debt being paid down by that amount. In addition, $536 billion over 15 years would be used to create Universal Savings Accounts, which would, to a substantial degree, also raise national saving. To the extent that you do not accept the President's proposal to transfer monies to Medicare or to enact universal savings accounts, that money should be transferred to Social Security and saved, rather than being used to enact a larger tax cut or increase other spending.

To the extent Congress saves the on-budget surplus and reduces the public debt, it is entirely appropriate to credit the Medicare and Social Security trust funds with those savings. Room will have been created in the budget for these transfers, and the dollars transferred will not be able to be used for tax cuts or expenditure increases. For every dollar of the on-budget surplus saved, you have contributed to strengthening the solvency of the Medicare and Social Security trust funds and also have reduced the public debt.

My generation — those born after World War II — are entering their peak earning years, and we know there will be budgetary pressures as the baby-boom generation retires. The choice you face is whether to give my generation a tax break for the next 10 to 15 years and let some future Congresses raise taxes on my children and grandchildren to meet Social Security and Medicare promises. I strongly urge that you save the surplus, including a significant portion of the on-budget surplus, to strengthen Medicare and Social Security.

Having said this, I do have concerns with aspects of the Administration's proposal for transfers to the Social Security trust fund. If not tied to structural reforms in Social Security, up-front crediting of $2.8 trillion over the next 15 years might encourage policy-makers to avoid needed structural changes in Social Security (i.e., reductions in benefits and increases in revenues). Indeed, the crediting the Administration has

proposed, coupled with a higher level of trust-fund investment in equities than the Administration has proposed, could make Social Security solvent over 75 years (or nearly so) without any structural changes to the program.

In addition, transferring large amounts of general revenue without making clearer the policy basis for the transfer, and without tying the transfer more tightly to the policy basis for it, could reduce public confidence in the program. Transfers from general funds need to be limited rather than open-ended and need to have a clear policy basis, with the amount transferred corresponding to the policy basis.

SPECIFIC SUGGESTIONS

I would therefore suggest that Congress consider the following guidelines for general revenue transfers.

- Transfers to Social Security or Medicare from on-budget surpluses, which would result in further reductions in the publicly held debt, are appropriate.

- In addition to any transfers from the on-budget surplus, further transfers are appropriate to the extent that Congress is unwilling to grant the authority to invest up to 50 percent of the OASDI reserves in equities (a smaller percentage than state and local pension funds invest in equities) under the management of an independent board. To the extent that such authority is not granted, general revenue transfers to compensate the trust fund for this lost income are appropriate. This policy (or better yet the actual investment of 50 percent of the trust fund in equities) would close slightly more than 50 percent of the 75-year financing gap.

- Explicit linkage of these transfers to other structural changes in the Social Security program should be considered (if this were done, approval of the transfers would be tied to approval of structural changes). Under this approach, the transfers could be used as an incentive to make structural changes. (I also would note that if Congress were to make the structural changes, program surpluses would grow larger, and either more monies could be invested in equities or larger transfers to Social Security from general funds would be justified.)

  The guidelines I have just outlined would allow for general fund transfers, but the authority would be limited rather than open-ended, would have a clear policy basis, and would be tied to (and reward) structural changes.

  (The Administration's plan also envisions that the half of the shortfall not closed by general-fund transfers be closed, in whole or large part, through more

traditional methods. The President has called for the specific changes to be identified and agreed upon through bipartisan negotiations. To reinforce this strategy, the Administration wants to "Save Social Security First"; it proposes that the increased discretionary spending and the USA accounts contained in its proposal not be created until Social Security solvency is restored. I assume this to mean that 75-year solvency must be restored, which in turn means that structural Social Security changes would have to be identified and enacted.)

- In addition, if Medicare is given sufficient transfers from on-budget surpluses, transferring back from the Medicare trust fund to Social Security the Social Security-related revenue that the Medicare trust fund now receives is appropriate. This would close about 15 percent of the 75-year financing gap. Social Security benefits for individuals above $34,000 and married couples above $44,000 are essentially taxed like private pensions. The revenue is placed in the Medicare trust fund, rather than the Social Security trust funds. (Some have suggested reducing this tax. I would urge you to reject that option, as it would increase the financing gap you would have to close and is unfair from an intergenerational equity point of view.)

- Finally, it is extremely important that all of the Social Security surpluses be walled off in a manner that precludes their being used for tax reductions or spending increases. These surpluses should be used solely for Social Security solvency. In addition, the pay-as-you-go rule should continue to apply until Social Security is solvent for 75 years. After that date, the pay-as-you-go rule should be modified so on-budget surpluses that remain after any transfers to Social Security and Medicare are made may be used for mandatory spending increases and revenue reductions. This rule should be enforced with a both a sequester and a 60-vote point of order. Other methods of enforcement such as counting public debt reductions as outlays also should be considered.

  I would urge that the Senate also adopt section 13302 of the Budget Act, which now applies only to the House. Conceptually, this rule says that any bill or amendment which weakens the solvency of the Social Security trust fund on a five- or 75-year basis should not be considered. The Senate has an alternative procedure that essentially makes this rule operative for 10 years, but not for 75 years. I recommend that you consider adopting this rule on a 25- and 75-year basis, with the point of order able to be waived only by a vote of 60 Senators.

CURRENT PROPOSALS UNDER CONSIDERATION IN THE CONGRESS

Contrast these suggestions to some of the approaches being considered in Congress. I have serious reservations about approaches that would use on-budget surpluses to provide tax cuts and use a large portion of the Social Security surpluses to establish

individual accounts. These plans will not reduce the publicly held debt very much, forcing Americans to pay higher interest bills than under a plan that does largely reduce or eliminate the publicly held debt.

For example, the Feldstein approach would *increase* our retirement-income promises to the elderly, since it guarantees all of the elderly's Social Security benefits *plus* a portion of the retirement income they would receive from government-funded individual accounts. Under this plan, government funds would have to be deposited in individual accounts on an ongoing basis, not just for 15 years. Yet federal interest costs would not have been appreciably reduced to help make room for these costs. The fiscal burden on future generations would increase. While we should, to the best of our ability, fund the promises we have made to the baby-boom and succeeding generations, the last thing we should do is to increase those cash retirement promises, particularly to the more affluent elderly, as the Feldstein plan does. (To be sure, there is a need to target some benefit improvements on widows, as the President has suggested, but such improvements should be offset with other benefit reductions.) In addition, these individual accounts are likely to undermine the long-run viability of the Social Security system as we know it today.

THE MAXIMUM TAXABLE WAGE AND THE PAYROLL TAX

The remainder of my testimony describes a menu of revenue options. Each of them has policy advantages and disadvantages. I am not suggesting you should adopt all of them. But none of them should be dismissed out-of-hand at this early point. They warrant review and consideration.

The Social Security payroll tax is not applied to all earnings. Only wages up to a limit called the maximum taxable wage are taxed, which in 1999 is $72,600. Wages exceeding this limit are not taxed. When the Social Security program began, the maximum wage base was set such that the payroll tax was applied to approximately 92 percent of wages for covered employees. Over time, the percentage of earning subject to the tax has declined.

In recent years, the distribution of earnings has become more unequal, with the earnings of high-paid workers increasing faster than average earnings. The maximum taxable wage is updated each year by the percentage increase in average earnings. Therefore, because the maximum taxable wage rises more slowly than the wages of high-paid workers, each year a smaller proportion of earnings fall under the maximum taxable wage. The ratio of taxable earnings to total earnings has fallen from around 90 percent in the early 1980s to 87.1 percent in 1997 and is projected to decline to 85 percent by 2007.

There is a limit to the amount of redistribution of income that should occur in a social insurance program. I would recommend raising and indexing the taxable wage base so it covers 87 percent of all earnings. This increase in the wage base should be phased in over a number of years. That would increase the total amount of earnings subject to the Social Security tax for workers at high earnings levels. It would have no effect on workers with earnings below the current level of $72,600 in 1999. This would close about 11 percent of the 75-year financing gap. An alternative proposal would insure that the percentage of earnings that are subject to the payroll tax declines no farther in the future than the level to which it has already fallen by 1999.

Taxing a higher level of earnings is justified not only because earnings at high levels have been increasing faster than average earnings, but also because cash earnings are becoming a smaller proportion of total compensation. Non-cash benefits, which are not subject to Social Security tax, have been rising both in actual amounts and as a proportion of total compensation. According to a study by the Pierce Brooks of the Bureau of Labor Statistics, benefits made up 27 percent of total compensation in 1986, rising to 28.1 percent in 1996.

The same study found the gap between total compensation costs of high-paying and low-paying industries was greater than the gap in wages and salaries alone. This indicates that workers in high-paying industries tend to have proportionately larger benefit packages than workers in low-paying industries. Since benefit packages are not subject to payroll tax, the proportion of total compensation on which workers contribute payroll tax is declining more for high-income earners than for low-income earners. Raising the maximum wage base will make the payroll tax more progressive with respect to both cash compensation and total compensation.

A legitimate argument also can be made for a small increase in the payroll tax rate at some point well in the future. Under the intermediate assumptions, taxable payroll as a percent of GDP declines from 41 percent today to 35 percent by 2075. Therefore as a percent of GDP, total FICA taxes are declining. Raising the payroll tax rate a small amount 30 or even 50 years from now to maintain FICA taxes at a constant percentage of GDP seems worthy of consideration. In the shorter term, however, consideration of changes in the payroll tax rate should probably be reserved for Medicare, where the financing needs are much greater.

ONE COULD TAX SOCIAL SECURITY BENEFITS LIKE PENSION BENEFITS

Under current law, beneficiaries with incomes over the $25,000/ $32,000 threshold pay income tax on up to 50 percent of their benefits. Up to 85 percent of benefits are taxed for individuals with incomes above $34,000 and married couples with income above $44,000. Beneficiaries with incomes below the $25,000/ $32,000 threshold are not taxed.

An argument can be made for taxing Social Security benefits like pension benefits. Taxing benefits in this way would meet two objectives. First, the method of taxation would make the treatment of Social Security benefits consistent with the tax treatment of other contributory, defined-benefit pension plans. That is, all benefits in excess of the contributions a worker paid in would be subject to income tax. Second, taxing benefits of current recipients gives some of the responsibility for bringing the Social Security system into long-term balance to current beneficiaries. Keeping the thresholds of $25,000/ $32,000 and taxing Social Security benefits as private defined pension plans would close about six percent of the 75-year gap.

EXPAND SOCIAL SECURITY COVERAGE

Currently, 95 percent of all jobs are covered by Social Security. The largest group of uncovered jobs are positions in state and local government. In 1994, some 5.5 million state and local government jobs — one quarter of all jobs at the state and local level — did not have Social Security coverage. All state and local employees who are not covered by Social Security are covered by a state or local pension program. State and local employees hired after March 1, 1986 are covered by the Medicare Program and must pay the Hospital Insurance payroll tax.

Over time, more and more of the employees of state and local governments have been brought under Social Security. One proposal that would complete this process would require all *new* state and local government employees to be covered by Social Security. This would increase the equity of the system by treating new state and local government employees just like other employees. The contributions of new state and local employees would be added to the trust fund for many years before most of them became eligible to receive benefits. This proposal would close about nine percent of the financing gap.

The provision covering all new state and local government employees should not take effect for a number of years — perhaps 10 years — in order to give state and local governments time to adjust to this change. In other words, it should apply only to new state and local government employees hired after some date such as January 1, 2010.

Extending Social Security coverage to all state and local workers is desirable for a number of reasons. For example, extending coverage would eliminate gaps in disability and survivor protection and provide for more inflation-proof pensions.

Some state and local governments would need to modify their pension systems to account for the fact that new workers would be entitled to additional retirement benefits. These governmental entities also would need to modify their budgets to include expenditures covering the employer's share of the Social Security tax. Many of the major Social Security proposals — including all three plans advanced by the Social

Security Advisory Council in 1997 and the NCRP and Moynihan bills — contain this provision.

CONCLUSION

In conclusion, I want to express general support for the Administration's framework. One of the two major issues surrounding the Social Security and Medicare debate this year is the extent to which we should use the unified budget surpluses to save Social Security by reducing the publicly held debt rather than spending the surpluses for either reductions in taxes or increases in spending. The other major issue is whether we should set up mandatory individual private accounts that would compete with Social Security.

On both of these issues I believe the Administration has followed the best course. The President has proposed that 77 percent of the unified budget surpluses be used to retire debt or be invested in equities. (While investment in equities would not reduce the amount of public debt, it is analogous in that it builds government assets.) Those monies would not be available for tax cuts or spending increases. As a result, the debt held by the public would fall from 50 percent of gross domestic product (GDP) in the 1993-to-1995 period to seven percent of GDP costs in 2014. Our net interest costs would fall from $243 billion (14.7 percent of the federal budget) in 1998 to about 2 percent in 2014 and be completely eliminated by 2018. This reduction in interests costs would make a very large difference in our ability to meet our Social Security promises.

In my view, the Administration also has made the right decision about privatization. It has not proposed individual accounts that use part of the existing payroll tax structure or accounts of which the proceeds are used to reduce Social Security benefits. It has suggested instead that a modest amount of the Social Security trust-fund balances be invested in equities. Other Center analyses explain why I believe these to be wise decisions.

Congress, working with the President, needs very much to supplement the President's framework by making structural changes to the Social Security program, including both benefit reductions and some of the revenue options discussed above.

Thank you for allowing me to testify on this very important issue.

CENTER ON BUDGET
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SHOULD A PORTION OF SOCIAL SECURITY BENEFITS BE INVESTED IN EQUITIES?

By Robert Greenstein[1]

In his State of the Union address, President Clinton proposed investing about 15 percent of Social Security reserves in the equities markets. Over the next 15 years, approximately $600 billion of budget surpluses would be invested in this manner on behalf of Social Security. The investment of these funds in equities markets would enable Social Security to earn higher rates of return and meet its long-term obligations without having to reduce benefits (or raise taxes) as much as would otherwise be the case.

This Administration proposal has sparked considerable controversy. This analysis examines some of the issues in the controversy.

Would Government be investing in the market and controlling private companies?

Critics of this proposal usually refer to it as "government investment" in the market. They warn of investments being made on a political rather than an economic basis.

Virtually all parties to this debate concur that no Congressional or executive branch involvement should be allowed in investing Social Security reserves in equities. As a result, the Administration's proposal is designed to preclude such involvement. The proposal would *remove* management of a portion of the trust-fund reserves from the executive branch and Congress and transfer it to an independent, non-political, professional management board structured so the board would be beyond Administration and Congressional control. This independent board, the members of which would be expected to have substantial experience in pensions and investing, would in turn contract with private fund managers selected through competitive bidding. These managers — which could include entities such as Merrill Lynch, Vanguard, or State Street Bank — would do the investing of a modest portion of Social Security reserves in broad index funds in the equities markets.

The investment consequently would be done by these private-sector pension managers, not by the government. Treasury Secretary Robert Rubin recently commented that "there [are] really two layers of protection" against political interference in this proposal. He noted "there'll be an independent body that will oversee the investment of the funds, and then the funds themselves will be invested by private sector money managers, not by the government. The government will be involved absolutely not at all in the investment."[2]

The investment would be done by private-sector pension managers, rather than by the government.

To ensure the independence of the professional management board that would select the private fund managers, the board would be structured like the Federal Reserve Board or the Federal Retirement Thrift Investment Board, the entity that oversees the investment of the funds that federal employees deposit through the Thrift Savings Plan. Federal Reserve governors serve

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staggered 14-year terms and cannot be removed for political reasons. The same type of approach would be used here. In addition, both the Fed and the Federal Retirement Thrift Investment Board are independent of Congress and the White House financially. They secure the revenues they need for operating expenses from very small charges on the investments they oversee; they are not dependent on actions of Congress or the President to secure their operating funds. That would be the case here as well.

With this structure, the Fed has successfully maintained its independence for decades in setting monetary policy; it, not Congress or the executive branch, establishes those policies. Since its creation in 1986, the Federal Retirement Thrift Investment Board has similarly maintained its independence and not been subject to political meddling. As Francis X. Cavanaugh, the Board's first executive director, has noted, Congress designed the board to be insulated from both political interference and corporate decision-making, and this design has worked.[3]

The Federal Retirement Thrift Investment Board also provides a model for how the Administration's proposal would work in another way. Equity investment by the Thrift Investment Board is limited to a stock index fund; the Board does not pick and choose among companies or sectors of the economy. The same would be true under the Administration's proposal. Equity investment would be limited to passive investment in very broad index funds, with neither the independent board nor the private-fund managers having authority to add or delete companies from the indices.[4]

The specter of a government behemoth — or of cadres of government bureaucrats wielding awesome market power for political purposes, making or breaking companies, and applying pressure to firms that are out-of-favor such as tobacco companies and businesses with which the government is engaged in legal disputes — appears to be based on misunderstanding of the Administration's proposal. The proposal would afford no opportunity for politicians to block investment in firms of which they disapprove.

The executive branch and Congress would be walled off from the investment process, just as they are walled off from Federal Reserve Board decisions on interest rates. In addition, the independent board overseeing the investment of Social Security trust fund reserves would itself have relatively little discretion or authority. Its functions would be restricted by law to selecting the private fund managers through competitive bidding (and possibly selecting the broad indices that could be used). Furthermore, while some critics have voiced concerns that the government might use the Social Security trust funds's ownership of stock to cast votes to influence corporate behavior, this, too, would be ruled out under the proposal; the board would be denied authority to vote the shares of companies that the trust funds hold. (See page 11 for a discussion of this issue.)

Critics Seek to Make Proposed Equity Investment Appear Larger Than it Would Be

Some opponents of trust-fund investment have sought to portray its dimensions as being larger than they actually would be. These critics cite figures on the total dollar value of equities the trust fund would hold several decades from now *without adjusting these figures for inflation.* These critics cite as the source for their data an analysis prepared by the Social Security actuaries. The actuaries' report shows, however, that in 1999 dollars, trust-fund investment would not exceed $750 billion even when earnings on the equity holdings were reinvested. The actuaries' report also shows that the amounts invested in equities would never exceed 15 percent of trust-fund reserves and would never constitute more than a very small share of U.S. equities markets.

The Independence of Thrift Savings Plan Investments from Political Interference

A recent *New York Times* article on the Clinton Social Security plan included an interview with Francis X. Cavanaugh, first executive director of the Federal Retirement Thrift Investment Board, which oversees the Thrift Savings Plan's investments. The *Times* reported that when was asked whether "the Government can invest in stocks without becoming bogged down in political shenanigans or corporate meddling, Cavanaugh replied: 'Can it be done? It's been done. We did it.' "

The article continued: "Strong legislation protects the [Federal Retirement Thrift Investment Board] from political pressure, [Cavanaugh] said. Corporate meddling is precluded because the commercial bank selected to manage agency investments also votes its shares on matters like takeovers and executive compensation. The only factor the bank can consider in casting its votes, Mr. Cavanaugh added, is what is best for retirees.

" '...The question is not can it be done. The question that should be asked,' [Cavanaugh] said, 'is whether the Congress, having protected three million Federal employees from political manipulation of their retirement funds, will be willing to extend that same protection to the 150 million beneficiaries of Social Security.' "[a]

In recent testimony Alicia H. Munnell, a Boston College economist who is a former senior vice president at the Boston Federal Reserve Bank and a former member of the President's Council of Economic Advisers, made a similar point. She noted that the Thrift Savings plan "has steered clear of any issues of social investing. TSP designers insulated investment decisions by setting up an independent investment board, narrowing investment choices, and requiring strict fiduciary duties. The TSP also operates in a political culture of noninterference. Its creators made clear from the beginning that economic, not social or political, goals were to be the sole purpose of the investment board. The TSP has perpetuated this norm by refusing to yield to early pressure to invest in 'economical targeted investments' or to avoid companies doing business in South Africa or Northern Ireland."[b]

[a] "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p. 16.

[b] Testimony of Alicia H. Munnell, before the House Ways and Means Committee, January 21, 1999.

In fact, while the *structure* of the new board would resemble that of the Federal Reserve in that the board would consist of members who were appointed to long, staggered terms and could not be removed for political reasons, the board's authority would be far more circumscribed than that of the Fed. The board would have only the rather mechanical function of selecting fund managers through competitive bidding.

Indeed, the structure and authority of the board would be essentially the same as that of the federal investment board established under partial privatization legislation that Senators Gregg and Breaux and Reps. Kolbe and Stenholm have introduced. The individual accounts that their legislation would create would be administered centrally, with the funds in these accounts invested by a board or institution managed by federal appointees. The board would select private fund managers and possibly the index funds to be used. *Its role and function would be virtually identical to those of the board the Administration has proposed.*

Still another safeguard could be erected by requiring the fund managers that invest the trust-fund reserves to pool the Social Security funds they are investing with other funds they are handling on behalf of private clients. This would

provide another layer of insulation against political interference. Any alteration in investments for reasons other than maximizing rates of return would provoke the wrath of the private clients whose funds have been pooled with the Social Security funds. The Federal Thrift Investment Retirement Board employs this approach.

This structure should place the investment of trust-fund reserves beyond political interference. In some ways, this proposal is best understood as a proposal to professionalize the management of Social Security reserves, diversifying the trust fund's investments so American workers can get a better return and moving the management of reserves not held in Treasury bonds outside the political realm and beyond the reach of elected officials.

Legislation establishing these safeguards could, of course, be altered by a subsequent Congress. But so, for that matter, could the legislation establishing the independence of the Federal Reserve Board and the Federal Retirement Thrift Investment Board — and that has not occurred. If it is politically taboo for Congress to intrude upon the workings and decisions of the Fed, decisions that have far greater economic consequence than those this new board would make in selecting private investment managers, it would likely be even more taboo for Congress to interfere with the professional management of the Social Security pension reserves of nearly 150 million workers and retirees. (A recent *Washington Post* article by Brookings Institution senior fellows Henry Aaron and Robert Reischauer explores these issues further. The article is reprinted at the end of this analysis on page 14.)

Would investing Social Security reserves in equities pose large risks for beneficiaries?

Suppose the stock market fell sharply and remained down for a number of years. If part of Social Security had been replaced by individual accounts, such a development would likely depress the retirement incomes of millions of workers. It should, however, have little effect on retirement income under the Administration's proposal.

The structure and authority of the board would be essentially the same as that of the federal investment board established under partial privatization legislation that Senators Gregg and Breaux and Reps. Kolbe and Stenholm have introduced.

The Social Security actuaries estimate that even after Social Security stops running annual surpluses, payroll tax revenues will remain sufficient to finance 70 percent to 75 percent of promised benefits. (This percentage will rise if, as the Administration has proposed, additional Social Security changes are made on a bipartisan basis so Social Security solvency is restored for the next 75 years.) Under the Administration's proposal, the Social Security system would retain the substantial majority of its reserves in Treasury bonds. These bond holdings would equal the full cost of several years of Social Security benefits. Between the ongoing revenue from payroll taxes, the interest and dividends earned on bonds and equities, and the revenue from redeeming bonds, the Social Security system would be able to ride out an extended stock market downturn without having to sell off stocks when stock prices were down. The trust fund would not need to cash in stocks during those periods, since it could finance benefits through payroll tax revenues and the redemption of Treasury bonds.[5]

This is precisely the result that corporate and public-employee pension funds seek by diversifying their assets. They place a portion of their portfolios in equities to take advantage of the higher rate of return that stocks provide over the long term, while placing other portions of their

Legislation establishing these safeguards could be altered by a subsequent Congress. But so could the legislation that established the independence of the Federal Reserve Board and the Federal Retirement Thrift Investment Board, and that has not occurred.

portfolios in investments that do not fluctuate in the manner that equities do. This generally enables these pension funds to avoid liquidating stock holdings during "bear markets."

The Administration proposal is quite cautious in this regard, involving very modest holding of equities. When the proposal was fully in effect, 14.6 percent of Social Security reserves — about one dollar in every seven in the reserves — would be invested in equities. By contrast, state and local public employee pension funds invest more than 60 percent of their assets in equities. Large corporate pension funds place more than 40 percent of their assets in equities. The Federal Reserve System's defined-benefit pension plan invests 65 of its assets in equities.[6]

To be sure, this approach is not without *any* risk. The stock market could fall sharply and not rebound for decades, although history suggests that is unlikely. Should that occur, modifications in the Social Security benefit and revenue structure would be needed. But the decisions concerning what modifications to make in the structure would be reached democratically through the actions of Congress and the President. Moreover, the burden could be spread broadly across generations and income strata to avoid drastic effects on individual retirees. By contrast, if part of Social Security is replaced with individual accounts and the market plunges and remains down, the effects on retiree incomes would be very uneven, with some individuals being hurt severely and likely subjected to poverty or near-poverty status for many or all of their elderly years.

How would returns compare to those that private accounts would provide?

The main argument advanced for converting part of Social Security to individual accounts is that such an approach would secure a higher rate of return. Investing a portion of Social Security reserves in equities also would secure this higher rate of return and would do so without exposing individual retirees and workers to the risks that individual accounts pose (and without risking the unraveling of the social insurance functions that Social Security provides, which are of particular value to lower-wage workers, widows, divorced women, and the disabled, among others).

In fact, as Brookings economists Robert Reischauer and Henry Aaron have shown, investing a portion of Social Security reserves in equities should yield a *higher* average rate of return than individual accounts. The administrative costs of managing 140 million to 150 million separate individual accounts would be much greater than the administrative costs of Social Security trust-fund investment. The higher administrative costs incurred under a system of individual accounts would eat up a larger portion of the investment earnings, yielding a smaller net return.

Assume that individual accounts would earn the average rate of return in the stock market. If a portion of Social Security reserves are invested in broad index funds, they, too, should earn the average market rate of return. The rate of return that determines the retirement benefits these investments actually can pay, however, is the *net* rate of return — the rate the market provides *minus* the amounts that administrative costs consume.

The Three Approaches to Securing Higher Returns Through Equity Investments

In recent months, three types of Social Security proposals have emerged for making investments in equities markets: 1) proposals to establish privately managed individual accounts; 2) proposals to establish individual accounts that have a limited number of investment choices and are centrally managed through a government-sponsored entity, patterned on the Thrift Savings Plan for federal employees; and 3) passive investment of a portion of Social Security reserves in broad index funds, as the Administration has proposed.

Privately managed individual accounts entail high administrative costs. The best evidence, reflected in the estimates of the Social Security Advisory Council, is that over a 40-year work career, administrative costs would consume an average of approximately 20 percent of the funds in such accounts. This percentage is likely to be higher for the smaller-than-average accounts that low- and moderate-income workers would have. Since some of the administrative costs are fixed and do not vary with the size of the account, these costs would tend to eat up a larger percentage of the funds in small accounts than of the assets in large accounts. Moreover, the 20-percent estimate reflects only the administrative costs and fees for managing these accounts. Converting the accounts to annuities when workers retire would entail additional costs; experts estimate those to average about 10 percent to 20 percent of the value of the accounts. Thus, administrative and annuitization costs could eat up 30 percent to 40 percent of the amounts in these accounts.

To avoid such high costs and to limit investment choices (and thereby reduce risks to individuals somewhat), proposals such as the legislation that Senators Gregg and Breaux and Reps. Kolbe and Stenholm have introduced would establish a system of individual accounts patterned on those available to federal employees under the Thrift Savings Plan. The accounts established through the Thrift Savings Plan are centrally managed by the Federal Retirement Thrift Investment Board, a board of professional appointees nominated by the executive branch and approved by Congress. Federal employees are offered several investment choices, including a stock index fund; the Federal Retirement Thrift Investment Board takes the deposits designated for the stock index fund and contracts with private fund managers who invest these funds. The Gregg/Breaux Kolbe/Stenholm legislation would adopt this model, setting up an independent board that would hire private fund managers to invest the funds placed in the individual accounts the legislation would create.

This is essentially the same system for investing funds as would be used under the Administration's proposal to invest a portion of trust-fund reserves in equities. Any risks of political interference in the investment process consequently would be similar under the Administration proposal and this legislation.

This leads two conclusions. First, if one wants to incorporate investment in equities into the Social Security system, one can do so *without* central management of such investments only if one adopts the approach — privately managed individual accounts — which entails very high costs that substantially reduce the retirement income the accounts can provide. Such an approach also imposes greater risk on individuals.

Second, a system of centrally managed individual accounts would use the same type of institutional structure to make investments as the proposal to invest a portion of trust-fund reserves in equities. Because a system of centrally managed individual accounts would entail substantial administrative costs to maintain and service nearly 150 million separate accounts, this approach entails costs that, while much lower than those of privately managed individual accounts, still significantly exceed those of trust-fund investment. A system of centrally managed individual accounts also would place more risk on individual beneficiaries than trust-fund investment would.

Using the official estimates of the Social Security Advisory Council, the fees that stock mutual funds charge, and the experience of other countries with private-accounts systems, Aaron and Reischauer have demonstrated that under a system of privately managed individual accounts where individuals can select freely among different types of assets, the administrative costs of managing the accounts would consume an average of about 20 percent of the funds in the accounts.[7] By contrast, the administrative costs associated with investing a portion of Social Security reserves in equities markets are projected to consume *less than one percent* of the amounts invested.[8] The net rate of return should consequently be higher under trust-fund investment than under private accounts.[9]

Would trust-fund investment result in excessive trust fund ownership of companies?

If investment of a modest share of trust-fund reserves in equities is approved, the legislation authorizing this investment could establish a low percentage limit on the proportion of the overall equities market that the trust fund's investments are allowed to constitute. The legislation also could set a very low cap on the percentage of the shares of any individual firm that trust fund's investments can represent.

Under the Administration proposal, trust-fund investments would equal slightly less than four percent of the equities market.[10] This is less than half the 10-percent share of the market that state and local public employee pension funds hold (and is the same or slightly less than the share of the equities market that Fidelity holds). The investment of public-employee pension funds in the market has not disrupted market operations.

Moreover, the board overseeing these investments would apportion the resources to be invested among the private fund managers it selects. It is likely that no single fund manager would handle trust-fund investments exceeding one percent of the market. By comparison, the funds that Fidelity invests equal four percent of the markets, while the investments the 10 largest private-sector fund managers handle all exceed one percent of the market.[11]

The Voting of Shares

Under the Administration's proposal, the legislation authorizing trust-fund investment also would establish procedures to ensure the independent board had no ability to influence corporate decisions by exercising voting rights on shares the board holds. These voting rights would be "sterilized" so they have no effect on corporate decision-making.

This can be accomplished in any of several ways. The legislation could adopt the approach the Federal Retirement Trust Investment Board employs; that board assigns voting rights to the private fund managers it selects through competitive bidding and requires these managers to vote shares solely in the economic interests of the shareholders. No political criteria may enter into the voting decisions. Alternatively, the legislation authorizing trust-fund investment could assign voting rights on shares the Social Security trust fund holds to the private fund managers but require the shares of each company to be voted in the same proportions that all other shares of that company are voted, thereby nullifying or "sterilizing" the effect of the trust-fund voting rights. The legislation also could simply require that voting rights not be exercised.

Brookings economists Robert Reischauer and Henry Aaron have shown that investing a portion of Social Security reserves in equities should yield a higher average rate of return than individual accounts.

The same issues regarding voting rights would be encountered under the partial-privatization legislation that Senators Gregg and Breaux and

State and Local Pension Funds, Equity Investments, and Political Interference

"Using a very comprehensive definition, a 1993 study for Goldman Sachs reported that economically targeted investment totaled less than 2 percent of total state and local pension fund holdings. Data from a 1996 survey by the Government Financial Officers Association show no evidence that state and local pension plans are sacrificing returns. Similarly, most of the divestiture activity, which centered on firms doing business in South Africa, ended in 1994."

Testimony of Alicia H. Munnell,
Boston College, before the House Ways and
Means Committee, January 21, 1999

From a recent *New York Times* report:

"State legislatures have occasionally ordered pension funds to abstain from certain investments — in companies doing business in South Africa during apartheid and, more recently, in tobacco companies. But most state pension funds with strong professional leadership have avoided interference by special interests, said Ian Lanoff, who ran the Labor Department's compliance program under ERISA, the Federal law governing private pensions, in the Carter Administration and who now specializes in pension law in Washington.

"He cited the refusal by New York City's pension funds to help bail the city out in its fiscal crisis in the mid-1970's and later refusal of Michigan public pension funds to help rescue the Chrysler Corporation. More recently, he said, the largest public pension funds have been largely successful in resisting efforts to ban investments in Northern Ireland and in companies involved in Holocaust reparations disputes.

"ERISA requires pension funds to base investment decision solely on the best interests of retirees, Mr. Lanoff said. Most states have taken ERISA principles and applied them to their own plans. Similar standards would help insulate a Social Security fund even further from political interference, he said."

"Social Security Investment Plan Raises a
Debate," *New York Times*, January 23, 1999,
p. 16

"...tobacco divestiture has been adopted by only two or three funds out of approximately 1,200 state and municipal government-managed trust funds."

Letter of Ian D. Lanoff,
Washington Post, February 8, 1999.

Reps. Kolbe and Stenholm have introduced. As noted earlier, their bill would establish an entity overseen by federal appointees and modeled on the Federal Retirement Thrift Investment Board to manage centrally the investment of hundreds of billions of dollars in individual accounts.

Would trust-fund investment cause a stock market bubble?

Another question that has been raised is whether the proposed trust-fund investment would pump so much money into equities markets that it would cause a stock-market bubble that could burst, injuring investors and the economy. This is highly unlikely.

Under the proposal, the investment of a portion of trust-fund reserves in equities markets would occur gradually over 15 years. Even at full implementation, the infusion of trust-fund reserves into equities markets would be small, totaling less than four percent of the market. Moreover, the amounts the trust fund would shift into the market each year would equal only about *one-quarter of one percent* of total market assets. This is a much smaller addition to the markets than private investors have been making in recent years and is much too small to cause serious market distortion. Treasury Secretary Robert Rubin has observed: "I think in terms of the impact on the market, [the trust fund investment] would really be of very little consequence compared to all else that's going on in the stock market in any given year."[12] Moreover, similar amounts would flow into equities markets under proposals to convert part of Social Security to individual accounts.

It also should be noted that to the extent federal policy decisions result in an increase in the amount of money flowing into equities markets, this will occur largely as a result of policies that boost national saving and pay down the debt held by the public, not because of trust-fund investment. Such policies would significantly increase the amount of private saving available for investment in equities. The effect that these policies would have on the amount of capital flowing into financial markets would be several times as large as the effect of investing a modest portion of trust-fund reserves in equities.

Would trust-fund investment cause the interest rates the federal government pays for Treasury bonds to rise substantially?

Another question that has been raised is whether investment of a modest portion of Social Security reserves in equities rather than Treasury bonds would cause the rates the federal government must pay for Treasury bonds to rise substantially. Here, also, the answer appears to be no.

If a portion of trust-fund reserves that otherwise would be used to purchase Treasury bonds is invested in equities instead, the Treasury would have to sell to private investors the bonds the trust fund otherwise would hold. The Treasury might need to offer somewhat higher interest rates than would otherwise be the case to attract these additional investors. The one significant study on this matter, however, estimates that if a portion of Social Security reserves are invested in equities, the interest rate the Treasury will have to pay for the bonds it issues will be only about one-tenth of a percentage point higher than would otherwise be the case.[13]

Moreover, the need to sell more Treasury bonds to private investors to replace bonds the Social Security trust funds otherwise would hold *also would occur under proposals to shift a portion of Social Security payroll tax revenues into individual accounts.* Under partial privatization approaches as well, the Social

Security trust fund would hold fewer Treasury bonds, causing the Treasury to have to sell more bonds to private investors.

Finally — and of no small importance — the Administration proposes to devote more than 60 percent of projected budget surpluses over the next 15 years to paying down the publicly held debt. As a result, the overall volume of bonds the Treasury would need to issue to investors would decline sharply even if a portion of trust-fund reserves are invested in equities. At the end of fiscal year 1998, debt held by the public equaled 44 percent of the Gross Domestic Product. The Office of Management and Budget and the Treasury project that under the Administration's proposals, including the trust-fund investment proposal, debt held by the public would fall to seven percent of GDP by 2014, which would be its lowest level in nearly a century (since 1917). Since the overall volume of Treasury bonds sold to investors would be much smaller than it is today, the real interest rates that the Treasury would have to pay to attract a sufficient number of investors to buy the bonds it offers would be lower than these rates are today.

(The fact that the interest rates the Treasury pays on its bonds will fall as the publicly held debt shrinks is another reason why it is important to permit the Social Security trust funds to diversify their investments. If the debt held by the public declines substantially and the interest rates the Treasury pays on bonds fall as a result, the interest rates the Social Security trust fund gets on the Treasury bonds it holds will decrease, reducing trust-fund income. Fairness should dictate that the Social Security trust funds be able to share in the economic gains the trust funds have made possible by making trust-fund reserves available to pay down the debt and boost national saving. At a minimum, the trust funds should not be injured by this economic progress. If the trust funds are permitted, however, to invest only in Treasury bonds — the yields for which are declining — Social Security beneficiaries will be injured and placed at a disadvantage relative to other investors.)

Investing a portion of trust-fund reserves in equities should have a positive effect on the federal budget.

Isn't the investment of a portion of trust-fund reserves in equity markets an "asset swap?"

Some, including Alan Greenspan, have pointed out that investing a portion of trust-fund reserves in equities does not benefit the overall economy since it would not increase national saving. The trust funds would receive higher rates of return from having a portion of their reserves invested in equities rather than lower-yielding Treasury bonds, but other investors would purchase the Treasury bonds the trust funds otherwise would have bought and secure modestly lower returns as a result. There consequently would be something of an "asset swap" — the trust funds would hold fewer Treasury bonds than would otherwise be the case, replacing a portion of them with equities, while other investors would hold somewhat fewer equities and more Treasury bonds than they otherwise would.

Although this point is correct, it often is misunderstood. *The same effect would occur if a portion of payroll tax revenues were shifted from the Social Security trust funds to individual accounts.* Since the trust funds would have fewer resources under these individual-accounts approaches, they would purchase fewer Treasury bonds. The Treasury would have to sell more bonds to other investors, who in turn would receive somewhat lower returns. The result, here also, would be an asset swap.

Thus, the fact that the investment of a portion of trust-fund reserves in equities would not itself boost the economy is not relevant to weighing the advantages and disadvantages of trust-fund investment versus other Social Security proposals. The trust-fund investment proposal is not

designed to boost national saving; it is designed to provide average workers, who tend to have little in the way of other financial assets, an opportunity to secure better returns. Moreover, by boosting the income the trust funds earn on their revenues, the proposal seeks to reduce the magnitude of the Social Security benefit reductions or tax increases that otherwise would be needed to make Social Security solvent over the long term.

Various approaches to Social Security reform can result in a long-term boost to the economy. To promote long-term growth, a Social Security plan must increase national saving and decrease current consumption. This can be achieved under either privatization or trust-fund investment proposals *if* budget surpluses are used to reduce the debt the federal government owes to the public or to promote saving in other ways (such as through the Universal Saving Accounts the Administration has proposed). Similarly, reducing benefits or raising taxes — and saving the revenue that such actions produce — should boost the economy over the long term. Whether one invests a portion of trust-fund reserves in equities, uses them to establish individual accounts, or follows neither route is not what determines whether a Social Security plan promotes saving and generates somewhat stronger long-term growth.

What is the effect on the budget?

Investing a portion of trust-fund reserves in equities should have a positive effect on the federal budget. If the trust funds earn higher returns, they will receive more revenue. This added revenue would be secured without cutting other programs, raising taxes, or borrowing. As a result of the added revenue, either Social Security benefits would not have to be reduced as much over the long term as otherwise would be the case or other parts of the budget would not have to be squeezed as much (or taxes raised as much) to secure the added funds needed to avoid substantial Social Security benefit reductions.

A corporate or public-employee pension fund manager who invested solely in bonds and had no holdings in equities would probably be discharged.

Conclusion

Virtually all private pension funds and state and local public-employee pension funds diversify their investments, taking advantage of the higher long-term rates of return that equities markets provide. A corporate or public-employee pension fund manager who invested solely in bonds and had no holdings in equities would probably be discharged.

Social Security, the basic pension plan for most ordinary American workers, should not continue being barred from diversifying its portfolio on behalf of its millions of beneficiaries. Management of Social Security reserves should be modernized and strengthened by moving a portion of it out of the executive branch and under an independent, professional institution that is insulated from politics and follows the types of management and investment principles — including diversification of investments — that private-sector pension funds employ. Investing a modest share of Social Security reserves in equities would strengthen Social Security's financial position to the benefit of future generations and reduce the magnitude of the Social Security benefit reductions or tax increases otherwise needed.

Notes:

1. This analysis benefitted from the comments and ideas of Henry Aaron, Alicia Munnell, Peter Orszag, Kathryn Olson, Wendell Primus, and Ellen Nissenbaum.

2. Interview with Secretary Robert Rubin on Good Morning America, January 21, 1999.

3. See "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p. 16.

4. A stock market index is a measurement of the return on a particular group of stocks. For example, the Standard and Poor's 500 index measures the average performance of the stock of the 500 largest publicly traded corporations. One of the broadest indexes is the Wilshire 5000, which measures the average performance of virtually all publicly traded stocks; more than 7,000 firms are represented in this index. The Administration's proposal envisions use of a broad index such as the Wilshire 5000 rather than an index like the S&P 500 that covers only the largest companies.

   Under passive index investing, as is done by the managers the Federal Retirement Thrift Investment Board selects and as would occur under the Administration's Social Security proposal, a fund manager purchases and holds the shares of all firms included in a particular index. The fund manager may not delete firms included in the index or invest in firms not reflected in the index. The fund manager thus cannot pick and choose among companies for political or other reasons.

5. Some Congressional opponents of trust-fund investment have argued that the trust fund would have to sell off significant amounts of equities in years before 2055. This argument rests on a dubious assumption — that nothing would be done either now or in the decades to come to restore Social Security solvency, except for the Administration's proposed transfer of 62 percent of current surpluses to the trust fund and the investment of one-fifth of these transferred funds in equities. Under such an assumption, the nation would stand idly by and watch Social Security go insolvent in 2055 and would have to cash in all of the trust fund's equity holdings in the years before then in order to continue paying full benefits until 2055. The Administration's proposal is to couple the transfer of funds to Social Security with changes that would be worked out on a bipartisan basis to restore Social Security solvency for at least 75 years. So long as such additional measures are taken, the trust funds should not need to cash in substantial equity holdings in the years before 2055.

6. To gain a sense of how limited the risks from the Administration's proposal would be, consider the following. In 2030, Social Security payroll taxes will be financing about three-quarters of Social Security benefits. The other quarter of benefits must be financed from Social Security reserves. Since 85 percent of these reserves would be in bonds and 15 percent in equities, only about four percent of Social Security benefits would be financed by redeeming equities if the bonds and stocks the trust fund held were redeemed in equal proportions. (About 25 percent of the benefits would be financed by redeeming bonds and stocks. Some 15 percent of the trust fund's bond and stock holdings would be in stocks. Multiplying 15 percent by 25 percent equals about four percent of Social Security benefits.) Now suppose the stock market plunges, falling 30 percent. This would affect only about one percent of Social Security benefits, since a 30 percent loss in value for the four percent of benefits financed by redeeming equity holdings would equal a 1.2 percent loss in benefits overall (30 percent times four percent equals 1.2 percent). Moreover, even this modest reduction of about one percent of benefits could be avoided by holding on to equities and redeeming a modestly larger number of Treasury bonds instead during the stock-market downturn.

7. See Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform: The Great Social Security Debate*, Century Foundation Press, 1998, pp. 85-88, and testimony of Henry J. Aaron before the Senate Budget Committee, July 23, 1998. See also statement by Peter Diamond, AARP Concord Coalition forum on Social Security, Albuquerque, July 27, 1998, and testimony of Peter Diamond before the Social Security Subcommittee of the House Ways and Means Committee, June 18, 1998. For a summary of this work, see Kilolo Kijakazi and Robert Greenstein, "How Would Various Social Security Reform Plans Affect Social Security Benefits?," Center on Budget and Policy Priorities, September 1998. The administrative-cost estimates cited here do not apply to individual accounts that are centrally managed and in which only a few types of investment choices are permitted, such as individual accounts patterned on those administered by the Thrift Savings Plan.

8. Under the Administration's proposal, the investment of a portion of trust fund reserves in equities would be handled in a manner similar to that which the Federal Thrift Savings Plan uses to make equity investments — through use of private fund managers and index funds. For every $100 in assets invested in equities, the TSP pays only about one cent per year in management fees; this amounts to an administrative cost of one-hundredth of one percent. Over a worker's 40-year work career, an annual charge on one hundredth of one percent would consume about two-tenths of one percent of the funds invested.

9. Henry Aaron stated this point succinctly in recent testimony. Aaron wrote: "The management of Social Security reserves would earn the average return generated by common stocks, which has exceeded that on bonds by an average of several percentage points per year. If individuals invested in common stocks, they too would earn the average return on common stocks. But their net return would be reduced by the sizeable administrative costs of managing more than 140 million mostly quite small individual accounts. By comparison, the administrative costs involved in managing investment of Trust Fund reserves in equities would be minuscule. Because administrative costs would be smaller, investment of part of the trust funds in equities would yield higher returns than individual accounts, while protecting beneficiaries from the risks they would bear under a system of individual accounts." Testimony of Henry J. Aaron, Senate Budget Committee, January 19, 1999.

10. The estimate made by the Social Security actuaries that the proposed trust-fund investments would equal slightly less than four percent of the equities market could prove to be a bit high. The actuaries conservatively assumed that the total size of the equities markets will grow in the future at the same rate as the Gross Domestic Product. If the size of the equities markets grows at a faster pace than GDP, the trust-fund investments would constitute a smaller share of the market than the actuaries have projected.

11. At the end of 1997, Fidelity held 3.95 percent of the U.S. equities market. See "America's Top 300 Money Managers," *Institutional Investor*, July 1998, p. 87.

12. Interview with Secretary Robert Rubin, Good Morning America, January 21, 1999.

13. Henning Bohn, "Social Security Reform and Financial Markets," in Steven Sass and Robert Triest, eds. *Social Security Reform: Links to Saving, Investment, and Growth*, Federal Reserve Bank of Boston, 1998.

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TUESDAY, FEBRUARY 23, 1999 A19

Henry J. Aaron and

Robert D. Reischauer

To the Market

In 1895 Lord Kelvin, president of the British Royal Society, declared that "heavier-than-air flying machines are impossible." In 1977 Ken Olson, the founder, president and chairman of Digital Equipment Corp., said, "There is no reason anyone would want a computer in their home." In 1981 Bill Gates, president of Microsoft commented that "640K ought to be enough for anybody."

Sometimes highly intelligent, esteemed and accomplished people can be wrong, even in their fields of expertise. And so when Federal Reserve Chairman Alan Greenspan declares that he does "not believe it politically feasible to insulate from governmental direction" Social Security investments in common stocks, his comments deserve serious consideration and critical evaluation, but not blind acceptance.

There is a legitimate question as to whether it is possible to invest a small part of Social Security reserves in common stocks—as the president has proposed—without risking political interference in private business decisions. But the answer should be determined by current experience and the credibility of the institutional safeguards proposed to insulate such investment from political forces, not by unsubstantiated fears.

Pension reserves of federal employees, the Tennessee Valley Authority and even Mr. Greenspan's own Federal Reserve system are now invested in common stocks, without any hint of political interference. The contributions of those covered by the Thrift Savings Plan can be invested in any of three funds, the largest of which is an index stock fund. As a safeguard, this fund is managed by a private investment company chosen through competitive bid. The company is required to pool the federal employees' funds with those it manages for private clients, another roadblock to possible political interference.

The protections against political interference in President Clinton's plan would be even stronger than those that have preserved the independence of the Thrift Savings Plan. An independent board would be established to select and oversee private fund managers. Like the Federal Reserve, which for decades has conducted monetary policy without congressional or executive-office meddling, members of this board would be appointed for lengthy, staggered terms, and neither the president nor Congress would be able to remove them for any reason other than malfeasance. The board would enjoy budgetary independence from Congress and the president because it would draw its operating expenses from tiny charges against investment income.

The private fund managers would be charged with investing a small portion of Social Security's reserves—about 10 percent—in broad market index funds. This statutory requirement for a passive investment strategy would preclude the potential for interference that would arise if fund managers picked particular stocks. Total holdings on behalf of Social Security would represent only a tiny share of outstanding shares—about 4 percent. There would be no opportunity for politicians to try to exclude shares of firms that engaged in practices they disapproved of—for example, manufacturing tobacco products, failing to provide workers' health insurance, or polluting the environment.

But critics rightly point out that neither current experience nor promised safeguards can absolutely preclude abuse. Some future Congress might use Social Security assets to interfere with private business decisions. And if there is a chance—any chance, however small—of such abuses, critics of the president's proposal conclude, we should deny workers the higher returns and larger Social Security benefits that investments in a diversified portfolio of stocks and bonds would provide.

But no public policy can meet the standard of zero possible abuse. If such a standard applied to all decisions, we would not have a standing army for fear some rogue general might run amok, or a Federal Reserve, because some Congress might interfere with its independence. In each case, Congress acted because the benefits were clear and safeguards minimized risks.

The Founding Fathers understood that every action of government carries some risk. But they did not geld government, because they realized that government must exercise power to promote the well-being of its citizens. Instead, they created safeguards to minimize the likelihood of abuse. That is precisely the approach embodied in Clinton's proposal.

The consequences of failing to invest part of the Social Security trust fund in assets with a higher return than the yield on government bonds are clear and inescapable. Social Security faces a projected long-term deficit. That deficit can be closed only by cutting benefits, raising revenues or boosting the return on the system's reserves. Taxes for workers will be higher or benefits for pensioners will be smaller if Congress fails to boost the yield on Social Security reserves by authorizing investments in a diversified portfolio, including private securities. Virtually every private pension fund invests in such a diversified portfolio, because everyone understands that this policy significantly raises returns to workers at negligibly increased risk. It's good enough for employees of the Federal Reserve and the federal government; why not for Social Security beneficiaries?

The writers are senior fellows at the Brookings Institution.

The CHAIRMAN. Thank you, Dr. Primus. Ms. Phillips.

STATEMENT OF MARTHA PHILLIPS, MEMBER, BOARD OF DIRECTORS, THE CONCORD COALITION, WASHINGTON, DC

Ms. PHILLIPS. Thank you very much for inviting The Concord Coalition to testify on the revenue side of the Social Security reform debate.

The Concord Coalition urges you strongly to avoid relying exclusively on tax increases to close to gap between future benefits and expected revenues. Even though the President has taken it off the table several times, at our meetings, we still run into people from a variety of groups who argue that Social Security's problems could be solved with a modest 2.2 percent increase in the payroll tax.

Our concerns with that are, one, increasing the payroll tax by 2.2 percentage points is a large tax increase, not a small one. It is not enough to get the job done. The payroll tax is a very heavy burden on working age people already.

Two, it would be generationally unjust to solve the problem by raising taxes on working age people while leaving affluent retirees unaffected at all. And last, if payroll taxes are raised for anything, it should be for Medicare which is in much greater difficulty. I would like to elaborate on just a couple of these points.

Two point two percent of anything seems like a small amount, but adding 2.2 percentage points to the current 12.4 percent payroll tax is an 18 percent increase, not a 2.2 percent increase. For a family with a $35,000 a year income, this increase would raise their FICA tax by $770.

Now, if a tax cut of $500 is meaningful and substantial, then certainly a tax increase of half again as much is also meaningful and substantial.

A 2.2 percentage point increase is not enough to do the entire job. That figure measures how much tax increase you need now in order to buildup enough principal and interest just to barely cover the program's cascading shortfalls over the next 75 years.

That might make sense for a program that has fluctuations like unemployment compensation, but Social Security has surpluses now and deficits forever after. That is why a 2.2 percentage point increase might cover deficits over the 75 years, but not in the 75th year, not even in the 40th year.

If you did raise taxes by 2.2 percentage points, by 2040, you would have total revenue from the payroll tax income and also the revenue from income tax on people who are taxed on their benefits of 15.4 percent of payroll. Benefits would cost 18.1 percent of payroll and you would have a gap. The gap would widen to 4 percent by 2070.

So you would need considerably more than a mere 2.2 percentage points to do the job. Payroll taxes are already a very heavy burden. They are the largest tax owed by three-quarters of American workers. For most families, it is the income tax, not the payroll tax that is their largest burden.

A table in my prepared statement shows that median income families paid almost twice as much in income taxes as they paid in payroll tax in 1962. By 1982, the two taxes were just about the

same, and the median income family in 1995 paid about 53 percent more in payroll tax than income tax.

Some people think a flat tax is a fair tax and the payroll tax is indeed flat. It does not care if the person earning $35,000 a year has a spouse who earns twice as much, a spouse who stays home with a handicapped child, or no spouse at all; whether the person is responsible for feeding 15 dependents or eats out every night at restaurants all alone.

So if you do not want to raise the payroll tax rate, what about increasing the FICA tax base? It is not true, as you sometimes hear that the FICA base has historically been at 90 percent of covered wages.

As this chart shows, since World War II, it did briefly touch 90 percent for 2 years. It currently stands at 86 or 87 percent of covered wages, which actually exceeds the historic average of almost 84 percent. Pegging the cap to 90 percent of covered earnings in 2000 would hike it from the $72,600 a year today to something over $100,000 by then.

What would happen if you raised the FICA base? Well, first of all, benefits would grow to huge amounts. Ultimately, six-figure monthly checks would be mailed to the likes of Bill Gates, Warren Buffet, and Ross Perot.

Even at these high levels, many with consistently high earnings would get back less in nominal dollars than they paid in, and if benefits were decoupled from earnings, as some suggest—you can just rake in the revenue, but not lose it on the benefit side—the return would be even worse. I think it would be so bad that if you want to strain the social contract past the breaking point, this is the option for you.

Self-employed people would be particularly affected. Self-employment earnings constitute only 7 percent of all covered earnings, but 20 percent of the earnings over $100,000. People with high earnings would become extremely creative in finding ways to recharacterize their incomes and restructure their businesses and convert their earned income into income from investments. Eliminating the FICA cap would bring back the time-honored American sport of tax avoidance with a vengeance.

What about taxing benefits, which we have not talked about much today? The administrative structure is already in place for fully taxing benefits and only those who could afford it would be affected.

High income beneficiaries might gripe, but equity would be against them as soon as they compared their circumstances to working age people with the same income level.

Take, for example, two couples in Fairfax, VA, in 1998. One is a 35-year-old working couple, one small child, $30,000 in self-employment income, and a condo worth $100,000. Their bill for the big four taxes—Federal and State income tax, Federal payroll tax, and local real estate tax—comes to $7,900 a year.

Now, their neighbors down the hall are a 70-year-old retired couple, same $30,000 a year of income split evenly between Social Security benefits and taxable investment returns, and an identical $100,000 condo. Their tax bill for the big four? Nothing.

How about the same couples at $75,000 of income and $200,000 condos? The working couple pays $26,100 in taxes, while the retired couple pays just $10,642. Of that, the extra 85 percent Social Security tax tier accounts for less than $1,500. These vast discrepancies are impossible to defend.

Since raising taxes and trimming benefits are so unpopular, it is tempting to look outside the box for other sources of revenue and the President has proposed tapping the budget surplus. The Concord Coalition supports reducing the publicly held debt as one of the best policies we know for increasing national savings, laying the foundation for long-term economic growth, and increasing standards of living.

Although the President's plan would leave the publicly held debt some $362 billion higher after 5 years than it would be under present law, it still would be lower than today. But leaving the surplus untouched by policymakers so that debt reduction can occur is a diabolically difficult policy to pursue.

Last October's glut of emergency spending that dipped $21 billion into the Social Security surplus more than proves this point. The Concord Coalition, after 6 years of hard work on this issue, has gradually become convinced it is not enough to move these surpluses off budget or park them in the trust fund, but that amounts that are set aside as pre-funding for long-term obligations, such as Social Security, need to be moved out of the budget.

That is why I think that some of the discussion about using the surpluses to fund individual accounts, being careful not to create a new entitlement to do so, but to do it on a contingent basis, some percentage of a surplus, if there is one, makes a lot of sense. Thank you.

[The prepared statement of Ms. Phillips follows:]

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Testimony by Martha Phillips
on behalf of the Concord Coalition
before the Senate Special Committee on Aging
March 1, 1999

Thank you for inviting the Concord Coalition to testify today on the revenue side of the Social Security reform debate.

The Concord Coalition is a bipartisan, nonprofit grass roots organization with members and chapters nationwide dedicated to generationally responsible fiscal policy and long term economic growth. Its co-chairs are former senators Warren Rudman (R-NH) and Sam Nunn (D-GA).

Concord is heartened that on-budget deficits are now smaller than they ever have been since Social Security was taken off budget in 1983 and on-budget surpluses now appear possible. This is attributable not only to years of Congressional fiscal discipline and hard political work but also to the strong growth in revenues as the nation enjoys the longest peacetime economic expansion in our country's history.

Unfortunately, today's healthy fiscal condition is unlikely to continue indefinitely. Nor is its favorable demographic pattern. Today we have a relatively small number of retirees compared to a relative large number of working age citizens. This is about to change, dramatically and permanently.

The large baby boom generation is poised to begin getting Social Security benefits in less than a decade. At the same time, longevity is also increasing, perhaps faster than official projections note. These twin pressures of increasing longevity and the baby boomers' retirement will result in an increase in the portion of elderly from about 12 percent of the nation's population today to 20 to 24 percent by 2040. Today's preschoolers, who will be working age taxpayers when that time comes, will find it a struggle to finance Social Security, Medicare, and large portions of Medicaid—the chief income security and health insurance supports for elderly Americans.

That is why Concord believes it is urgent to use the current political, fiscal, economic and demographic windows of opportunity to undertake reforms now of these programs. Waiting until changing demographics overtake us can only make the task more difficult and the impact on individuals more abrupt and painful. There is widespread consensus that, even though Medicare is a more serious

and difficult problem to solve in the long run, Social Security reform is do-able, ripe for debate, and should be at the top of the agenda in 1999.

Reduced to its fundamentals, the problem ahead for Social Security is that the growing real benefits promised under current law cannot be financed by the revenue structure that is now in place. Options to solve that problem fall into two boxes: reducing future benefits from promised levels or increasing the revenues flowing into the system. Some suggest that proposals to establish individually-owned Social Security investment accounts constitute a third box. But these individual-account proposals, reduced to their fundamentals, nevertheless rely on some combination of increased revenues from taxes and/or investment to support retirement benefits as well as a scaling back of benefits offered under the traditional Social Security program.

My testimony today focuses on issues associated with increasing revenues used to finance Social Security and, specifically, the tax aspects of the Social Security reform debate.

The Concord Coalition strongly urges you to avoid relying exclusively on tax increases to close the gap between future benefits and expected revenues.

Closing the gap by relying solely on taxes would constitute an impossibly burdensome tax increase, would have negative labor force consequences, would be generationally unfair, and would use resources that might be needed for other purposes in the future, including dealing with intractable Medicare problems.

It is frequently suggested that a tax rate increase of "merely 2.2 percent" of payroll is all that is required to fix Social Security for the next 75 years. This description of the situation is misleadingly benign.

First, it makes the tax increase seem a lot smaller than it would be. Two percent of *anything* doesn't seem like much. But when one considers that the entire employer/employee payroll tax supporting Social Security retirement, survivors, dependents and disability benefits is 12.4 percent, adding another 2.2 percent means an increase in the payroll tax of close to *18 percent.* For a family with $35,000 income, the increase would raise total FICA, including the 2.9 percent that supports Medicare, from $5355 annually to $6125, an increase of $770. A tax cut of $500 is often described as a meaningful and substantial amount; so is a tax increase of half again as much.

Second, increasing the payroll tax by 2.2 percentage points wouldn't do the job. The 2.2 percent is based on what is needed today to close the long-term 75-year actuarial deficit. Seventy-five years sounds like a long time, and securing the future of Social Security for 75 years seems like a cautious, prudent thing to do. But there's a catch. The 75-year approach that is so frequently used does not ask how much it would take to make the program sound in the 75th year. Instead, this calculation assumes that surplus revenues collected today will be invested in safe government securities so that both principal and interest can be used later when large deficits occur. This calculation therefore assumes that in the 76th year, no assets will remain and that revenues from payroll tax and taxation of benefits will be sufficient to pay only 75 percent of benefits. So this calculation turns out not to be prudent or cautious at all.

Such an approach makes sense for programs such as, for example, unemployment compensation, where the business cycle results in alternating periods of high and low unemployment. States build up reserves during times of low unemployment and then use their reserves to finance benefits when unemployment is high.

But Social Security's projected path is quite different. Instead of recurring cycles of lean and plenty, Social Security's path is one of surpluses in the years just ahead, followed by a steady, unbroken, long-term decline to ever greater annual deficits. By 2032, the year Social Security is projected to use up the last of its bonds and interest, the OASDI trust funds will be running an annual operating deficit of more than $240 billion measured in 1998 dollars. This certainly puts the concept of 75-year "solvency" in a whole new light. The $240 billion is to be supplied, actuarial projections assume, by cashing in the last remaining bonds held by the system. The following year, the deficit will be even larger, but there won't be any more bonds. At that point it won't matter much that, back in 1999 or 2002, the program enjoyed annual surpluses. Those surpluses won't help pay the biils in 2032 or in 2074. [1]

Suppose that we did agree to increase payroll taxes, starting right away, by 2.2 percent. When we get to, say 2040, benefits are expected to cost 18.13 percent of payroll but revenues, even with the additional 2.2 percentage points, would be only 15.38 percent of payroll, leaving a gap of 2.73 percent of payroll. And this is, of course, exclusive of any Medicare shortfalls we might also be experiencing.

How much would payroll taxes have to be increased to put the program into balance 75 years from now? Last April, the Social Security Trustees' Annual Report indicated that, on the intermediate path, OASDI benefits would cost 19.79 percent of payroll in 2075—6.43 percent of payroll more than income into the trust funds from payroll tax and taxation of benefits. Since the intermediate path makes assumptions about longevity gains that may be too conservative and assumptions about growth in labor productivity that may be too optimistic, the cost of the current program could even be larger.

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[1] As an aside, the fundamental assumption that surpluses invested in government bonds will provide substantial revenue to the program in the future is perhaps not as sound as it may first appear. It's true that Federal Treasury bonds are one of the safest investments in the world, backed by the full faith and credit of the U.S. government. But the bonds that now are counted as assets of the Social Security program are, at the same time, future liabilities of the government. Converting Social Security's paper assets into cash with which to pay benefits will require the government in the future to squeeze loose the funds out somehow -- by reducing other spending, increasing taxes, or trying to support the shortfall through borrowing (which it won't be able to do for very long given the magnitudes involved.). These unattractive options might be more feasible if we had a robust, growing economy that enjoyed much higher per capita GDP than the levels currently projected for the 2030s and beyond. Such an economy would be spurred through saving the Social Security surpluses accruing now and increasing the stock of capital available for investments that increase economic productivity. However, not once since Social Security surpluses began to build up as a result of the 1983 reforms has the full surplus been saved. Every dollar has been used to finance on-budget deficits of the federal government. Last year, for example, while newspaper headlines blasted out the news of a $70 billion budget surplus, the reality was that on-budget accounts had a $29 billion deficit that was masked by Social Security's $99 billion surplus. On this path, the notion of having an economy rich enough to support using the assets of the Trust Fund to meet benefit obligations in the future is far from certain. It is far more likely that severe fiscal pressure will begin building about the time baby boomers begin retiring and Social Security's income from FICA and income taxes is no longer sufficient to pay for benefits.

Annual OASDI Operating Balance as % of Payroll[2]		
	Current-Law	With additional 2.2%
2000	1.48	3.68
2010	0.54	2.74
2020	-2.26	-0.06
2030	-4.66	-2.46
2040	-4.95	-2.75
2050	-5.07	-2.87
2060	-5.75	-3.55
2070	-6.20	-4.00

The bottom line is that if you wanted to solve the entire problem by increasing payroll tax rates, not only for 75 years but for the *indefinite* future, an increase of 4.7 percent would be required, not 2.2 percent. This would be a *38 percent increase* over the current rate and would put the total payroll tax rate at 17.1 percent[3] (assuming that current-law provisions that tax benefits for higher income retirees would also continue to supply revenue to the program.)

Payroll tax is a heavy burden:

Another reason to avoid raising payroll tax rates above their current levels is that payroll taxes are already the largest tax owed by three-quarters of American workers (counting the employer's share but not the 2.9 percent Medicare tax.) Many in Congress are urging large income tax cuts this year to give tax relief to beleaguered taxpayers. But for most families, it's the payroll tax that is the largest burden. Many millions of American tax filers are not tax payers because, after taking into account their dependents, deductions, tax credits and other factors they do not owe any tax under our progressive system of taxation. But we seldom focus on the fact that a great many of those who are deemed not to have enough income to owe federal income taxes nevertheless must contribute 15.3 percent of their earnings in payroll taxes.

Over time, the flat payroll tax has come to provide a much larger share of federal revenues than it did in past decades. While personal and corporate income taxes have declined as a share of overall revenue and a percent of GDP, the regressive payroll tax has increased. In fact, it has increased about 3 percentage points per decade.

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[2] Data from 1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

[3] Unpublished estimates provided by SSA actuaries, cited in testimony by Jagadeesh Gokhale, Federal Reserve Bank of Cleveland, before the Senate Budget Committee, January 19, 1999.

Income, Income Tax and Payroll Tax Liability (for a Median Income Family)					
	1962	1972	1982	1992	1995
Median income family of four	6,756	12,808	27,619	44,615	49,531
Income tax liability	736	1,359	3,792	4,412	4,947
Payroll tax liability (employer, employee shares)	300	936	3,700	6,826	7,578
Income tax +/- payroll tax	436	423	93	-2,414	-2,631

Source: Joint Committee on Taxation, JCS-8-97

The payroll tax is a flat tax. Some people think flat taxes are fair; after all everyone pays the same rate, and what could be more fair than that? But in thinking about raising payroll tax rates, it's important to remember that unlike the progressive income tax, which at least attempts to relate tax burden to people's ability to pay, the payroll tax is blind. It doesn't take into account whether the worker who earns $35,000 a year has a spouse who earns twice as much, a spouse who stays home to care for a handicapped child, or no spouse at all. It doesn't care whether the worker supports only himself or herself or has a dozen dependents.

Generational equity:

Raising payroll taxes puts the burden of saving Social Security squarely on the shoulders of those who are working today and the generations that follow them. The generation that has already retired is not affected by this change.

This is ironic since retirement benefits paid to today's beneficiaries provide an excellent return on the taxes they paid in during their working lives. In contrast, young people entering the workforce today can look forward to meager returns on their payroll taxes, and many will actually receive a negative rate of return. Eugene Steuerle and Jon Bakija calculated that after taking into account spousal and survivor benefits and the possibility of dying before retirement age, the real internal rate of return will decline dramatically under the current program for younger cohorts (assuming that full benefits somehow will be paid after 2032.) An average-income one-earner couple in their late 70s today (born in 1925) enjoys a 5.66 rate of return, considerably more than their grandchildren (born in 1975) who can count on a 3.41 rate of return for a one-earner couple or 2.34 percent for a more typical two-earner couple.[4] Geoffrey Kollmann has calculated that it took 2.6 years for an average earner, with a dependent spouse, who retired at age 65 in 1980 to recover the combined employee-employer OASI taxes; the same worker retiring in 2020 would need 20.2 years to recover his or her taxes and a maximum earner with

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[4] C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century*, Urban Institute Press, Washington DC, 1994.

dependent spouse would not recover the taxes for nearly 35 years—assuming he lived to 100.[5]

Today's oldest retirees are the lucky beneficiaries of the start-up period for the Social Security system when payroll tax burdens were low, while young people now entering the workforce are getting into a mature system. Thus, it is unrealistic to expect that younger workers will ever get the rates of returns their parents enjoyed. But that's no justification for making the deal worse for workers in the future. Generational fairness argues against raising payroll taxes for younger workers: it would worsen their rate of return but leave unaffected those who are already receiving benefits, regardless of their wealth.

It is true that Social Security includes disability protection as well as the retirement, dependent and survivors benefits used in the rate-of-return calculations cited above. But, even taking disability coverage into account, the return is poor for today's workers and getting worse. Increasing taxes would make the deal even worse for younger workers. Indeed, it is the poor rate of return that younger workers expect to get that has fueled much of the interest in establishing individual accounts that can take advantage of the higher rates of returns associated with market investments.

Medicare challenges still loom:

The Social Security program does not exist in a vacuum. Making Social Security sustainable would not be nearly so difficult if it were not for the even greater dilemma of addressing projected Medicare shortfalls. For seniors, adequate and affordable health insurance is just as important a part of retirement security as income, and for some, perhaps, more important.

The outlook for the Medicare program is affected not only by the trend toward an older population but also by the prospect of increasing per-capita expenditures as medicine becomes more intensive and a greater portion of beneficiaries are in the over age-85 group that uses medical services to a greater extent than "young" retirees still in their late 60s. On the current path, the question is not whether Medicare eventually will cost more than Social Security, but when. What's more, official projections are, if anything, overly optimistic. They include an assumption that Medicare costs will gradually stop climbing at their current rate, although no one knows how, or when, this de-escalation will occur.

Conventional cost-cutting measures, such as managing care, reducing payments to providers, increasing premiums and co-payments, and combating waste and fraud will not suffice to keep Medicare shortfalls in check. A strong possibility exists that additional revenues will be needed to finance Medicare in the future, particularly if Congress decides to broaden Medicare coverage to include prescriptions and other services routinely included in employer-provided health insurance.

The bottom line is that revenues dedicated to making Social Security sustainable cannot also be used to shore up Medicare. In an ideal world, Congress might choose to resolve the more difficult Medicare dilemma first, and then move on to the "easier" problems facing Social Security. In the real

[5]Geoffrey Kollmann, *Social Security: The Relationship of Taxes and Benefits for Past, Present, and Future Retirees,* Congressional Research Service Report 95-149 EPW, May 12, 1998.

world, Social Security is first up. Care should be taken in solving the Social Security problem not to use resources that will be needed in the future for Medicare. This means that the revenues going into the Medicare HI Trust Fund from taxation of Social Security benefits should not be reclaimed by Social Security.

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<u>To the extent that revenues are increased, what are the options?</u>

The case against relying *exclusively* on a FICA rate increase to solve the Social Security problem is compelling. However, if political leaders conclude that *some* increase in revenue into the traditional Social Security program will be part of the solution that ultimately is cobbled together, what are the options? They include:

- raising the tax rate by a small amount,
- raising the earnings base on which the tax rate is levied,
- increasing the tax levied on benefits received by retirees, and
- expanding the base beyond earnings, or even abandoning payroll tax in favor of some other tax base.

Settling on an acceptable set of revenue increases as part of the ultimate Social Security "fix" won't be any easier than agreeing on ways to reduce future benefits. Indeed, there are fierce advocates for *reducing* payroll taxes and taxes on benefits. But unless future benefits are brought into line with future tax revenues, the Social Security program will not have been made sustainable. "Reforms" that rely on promises that future generations of workers will make good on benefits pledged by today's politicians will not make the program more affordable in the future. Worse, if such reforms give the impression that the Social Security Trust Fund is flush with surplus resources, future Congresses might be tempted to increase promised benefits still further, as has happened so many times in the past.

<u>Raising FICA rates:</u>

FICA is a flat tax, so any increase in the rate will apply to every worker, regardless of economic circumstances. The burden of this tax on lower wage workers, on single mothers striving to maintain middle class incomes, on youth seeking part-time employment and struggling young families is already great. (Even though the Earned Income Credit helps offset some or all of this burden, very few workers see the EIC in their paychecks and many do not file the tax returns necessary to benefit from the credit.) Increasing the FICA burden should be considered a last resort. Indeed, President Clinton, at the forum Concord and AARP hosted in Kansas City in April and again at a forum we hosted in August in Albuquerque specifically ruled out FICA rate increases.

In addition to the regressive nature of this tax and the fact that it is the largest of the "big four"

taxes[6] that three-quarters of working age families pay, there are labor force considerations as well. The payroll tax has a negative effect on work incentives, wages, and job creation.

FICA taxes are divided evenly between employees and their employers. But just because employers appear to pay half doesn't mean that employees don't ultimately bear the burden of both halves of the tax. Indeed, the economic effect of the FICA tax is the same as if employees were paying the entire 12.4 percent out of their paychecks. This is because employers can devote only so much to hiring labor and still make adequate profits. The more that goes for payroll taxes, or for fringe benefits, the less that is available to be paid directly in wages. Because of FICA, it costs an employer 12.4 percent more to hire an employee than that employee takes home in wages. This wedge has an impact on hiring, pay and job creation decisions.

If the payroll tax rate were increased, it is unlikely that workers' pay would drop overnight in response. In today's hot labor market, pay probably wouldn't drop at all. But the results nevertheless would be felt in time as pay increases came more slowly or, in some cases, did not come at all. And the additional payroll tax could be the last straw tipping some employers to calculate that it would be more profitable to install machines rather than hire more human workers.

Another negative impact of a FICA increase is that entry level jobs would become more expensive for employers to create, and this would tend to suppress job creation. With states trying to help millions of single mothers move from welfare into the work force, almost always at entry levels, and growing numbers of high school and college graduates poised to enter the work force, a FICA rate increase would be a move in the wrong direction. At higher wage levels, employers can slow down pay increases and promotions to gradually offset the impact of FICA rate increases. But near the minimum wage, employers cannot pass on the burden of payroll taxes increases to their employees.

Raise wage base:

If raising the FICA tax rate would have such undesirable consequences for average and lower-wage workers, what about raising the tax base on which the tax is levied?

FICA taxes are levied this year on the first $72,600 of wages earned by each worker. Of course, the vast majority of American workers do not have wages this high, so they are personally indifferent as to where the tax base cap is set. However, currently about 14 percent of wages earned in covered employment exceed the cap and therefore are not subject to FICA. This 14 percent of wages is earned by about six percent of the 140 million workers in the nation who have some wages in excess of the FICA wage cap. They are the ones who would be affected by an increase in the tax.

Since the tax base ceiling is indexed to average wages, and since earnings at the top of the income distribution have been growing faster than average earnings, the share of all earnings that is taxable has consequently declined. Some have suggested raising the tax base cap from its current level of about 86 percent of covered wages back to its "historic" level of 90 percent. However, it is just not true that 90

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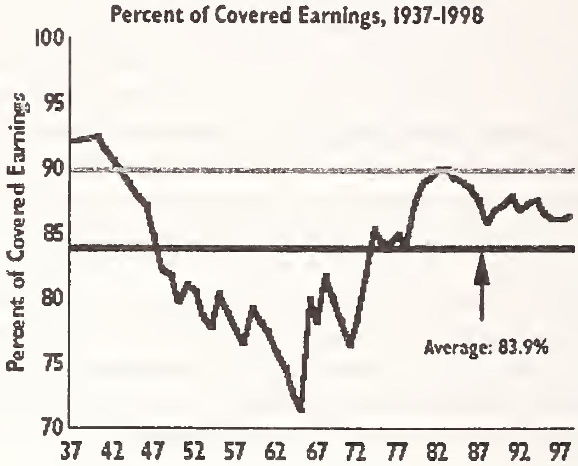
[6] Federal and state income taxes, federal payroll taxes, and local real estate taxes

percent is the historic average. In fact, it's closer to the historic high water mark.

Social Security Taxable Earnings as a Percent of Covered Earnings, 1937-1998



Although the ceiling on FICA wages has declined as a percentage of covered earnings lately, it seldom has been as high as 90 percent. The long-term historic average is just under 84 percent since 1937. The average over the last 50 years since 1949, has been 82.6 percent. Even the last 20 years, since 1979, the average has been 87.7 percent. During the 1950s and 60s, the taxable share of earnings fluctuated between 71 and 82 percent. In the 1970s, Congress passed legislation that sharply raised, and indexed, the tax base. But even so, the share of *earnings beneath the cap has remained less than 90 percent in all but two years*, the recession recovery years of 1982 and 1983. In this perspective, today's 86 percent level isn't terribly out of kilter with the program's history. And to argue that 90 percent is simply the historic level is dead wrong.

However, if you argue that a reason to raise the wage base is that growing wage inequality has resulted in the base covering a lower percent of earnings, then there is some merit—if you believe that the difficult post-recession 1981 to 1984 years were the model to follow. Even then, you should consider the latest statistics that indicate wages for the lowest paid part of the work force finally are beginning to be pulled up by the current extraordinary business cycle and are growing faster than wages at other pay levels. It may turn out that the percent of covered payroll may halt or even reverse its recent decline.

Suppose you decide to raise the cap to 90 percent and hold it there. How much of the problem would this solve? About one-fifth of Social Security's long-term trust fund deficit. If you want to solve more of the problem this way, consider that you would have to more than *double* the cap to get even half the savings you could get by eliminating the cap altogether. To get two-thirds of the savings, you would have to *triple* the ceiling on the tax base.

Pegging the base to 90 percent of the covered earnings in 2000 would mean increasing the base from today's $72,600 to about $100,000. Obviously this will be a popular option for the vast majority of American workers whose earnings are less than that amount, and they would see such an increase as

equitable. But suppose you decide to eliminate the cap altogether and tax 100 percent of earnings. Here are some likely results:

- Benefits in the future would grow to huge amounts since benefits are related to taxable wages. The benefit formula could, of course, be changed so this wouldn't happen, but that would make Social Security an even worse deal than it already is for high earners. If benefits were permitted to grow, they still would be a lousy return on the money paid in. Even so, benefits would be huge in absolute terms. Ultimately the effect would be to increase the cost of Social Security so that six-figure monthly checks could be mailed to the likes of Bill Gates, Warren Buffett and Ross Perot.

- Even at these high levels, many with consistently high earnings would get back less in *nominal* dollars than they paid into Social Security. The analogy is to putting your money in the bank, and instead of getting interest, the bank takes money out of your account.

- As we learned all too well when income tax marginal rates were quite high, people with high earnings, self-employed as well as others, become extremely creative in finding ways to re-characterize their incomes and restructure their businesses to convert as much as possible of their earned income into income from investment. Tax avoidance is a time-honored American tradition, and eliminating the FICA cap would bring it back with a vengeance.

- The self-employed would be particularly affected. While self-employment earnings comprise only 7 percent of all covered earnings, they comprise nearly 20 percent of earnings above $100,000. Much of this income represents a return to capital invested in small businesses. If you raise the cap substantially, prepare to see many of these businesses hire lawyers to figure out ways around the cap.

Many are calling for not merely raising the cap on taxable wages but eliminating it altogether. President Clinton ruled that out in the Social Security Forum in Kansas City last April, saying it would solve only a portion of the problem but at the cost of tremendously changing the whole Social Security system because there no longer would be a correlation between taxes paid in and benefits received.

Nevertheless, some see eliminating the cap as the reverse of affluence testing on the benefit side. But there's a fundamental difference. Both reforms would move Social Security away from individual equity. But an affluence test would do so by emphasizing social adequacy more, while hiking the tax base would emphasize it less. Both reforms would help bridge Social Security's long-term deficit. But an affluence test would do so by decreasing the system's long-term cost, while hiking the tax base would do so by increasing it.

Some people argue that means testing Social Security by reducing benefits for affluent retirees would weaken the collective bonds that have been such an important part of the Social Security tradition in America. I would argue that eliminating the cap on wages is a far surer way to destroy that bond. The tax levels that some people would be required to pay are far more likely than means testing benefits to create resentment and opposition.

Taxing benefits:

One way to bring benefits into line with revenues is to affluence-test the benefits. The Concord Coalition has long advocated this approach on grounds of equity and fairness. Only those who could best afford to have their benefits reduced would be affected. Public opinion polls show greater support for this option than for almost any other, and it is favored by rich and not-rich alike. This single change would go a long way toward solving the problem. Appendix III of the 1994 Advisory Council on Social Security Report indicated that the plan Concord advocates would improve the long-range OASDI Actuarial balance by 1.65 percent of payroll. In its 1997 volume on Spending and Revenue Options for Reducing the Deficit, the Congressional Budget Office calculated savings from reducing entitlements (Social Security, Medicare and other non-means tested entitlements) to middle and high-income families at between $50 billion and $60 billion annually. The budget savings from reducing just Social Security would approach $35 billion annually. Despite widespread public support and the large savings that it would achieve, policy makers have not embraced this proposal.

Another method for reducing net benefits to retirees with the highest incomes would be to make entitlements fully subject to individual income tax.[7] Currently, taxation of benefits generates $9 billion for the OASDI programs and another $5 billion for the Medicare Part A program. If the thresholds were eliminated and up to 85 percent of all benefits were includable in federally taxable income, amounts equal to about 0.21 percent of payroll would be raised. Thus, this option would not go as far as explicit means testing toward making Social Security sustainable over the long term.

Nevertheless, there are several reasons to give this option serious consideration. First, unlike an explicit means test, for which a new administrative structure would have to be established, increased taxation of benefits could be accomplished with the federal income tax system currently in place.

Yes, it's true that taxing benefits more would worsen workers' return on the amounts they paid in over the years. But the deal would be worsened only for those who could afford it. High income beneficiaries might gripe, but equity would be against them as soon as they compared their circumstances to working age people at their same income level. Take, for example, two married couples residing in Fairfax, Virginia, in 1998. One is a 35-year-old working couple with one small child, $30,000 in self-employment income, and a condo worth $100,000. Their bill for the "big four" taxes—federal and state income taxes, federal payroll taxes, and local real estate taxes—comes to $7,906.

Now consider their neighbors down the hall—a 70-year-old retired couple with the same $30,000 in income, split evenly between Social Security benefits and taxable investment returns, and the same $100,000 condo. How much does this retired couple pay in the big four taxes? Nothing. They owe no FICA tax since none of their income comes from earnings. With their personal exemption and total

[7] Under current law, beneficiaries with income of more than $25,000 if single and $32,000 if married must include up to half of their benefits in their taxable income. Revenues from this provision are credited to the OASDI Trust Funds. Those with incomes of more than $34,000 if single and $44,000 if married must include up to 85 percent of their benefits in their taxable income. Revenues from the 85 percent increment are credited to the Medicare HI Trust Fund.

exclusion for Social Security benefits, they owe no federal income tax. And they owe no state and local taxes because Fairfax County, like many jurisdictions, waives property taxes for seniors (but not the young) beneath certain income levels.

Now imagine that the same couples have $75,000 incomes and $200,000 condos. (Assume that the retired couple gets maximum Social Security benefits and that the rest of their income is taxable investment returns.) In this example, the working couple pays $26,101 for the big four taxes while the retired couple pays just $10,642. Of that, the extra 85-percent Social Security tax tier accounts for exactly $1,446.

Although some seniors complain today that *any* of their Social Security is subject to income tax, most understand that the vast discrepancies between their burden and that of younger families with identical income and greater expenses are impossible to defend.

Shortly before last fall's elections, there was brief talk about reducing the federal income tax on Social Security benefits. Fortunately that idea, which would have been a move in the wrong direction, was dropped once the election was past.

Going Outside the Box

Because changes in taxes or benefits are so politically contentious, there is an understandable temptation to look outside the box for some other way to bring more income into the system, in order to sustain the current program without reducing anyone's promised benefits. The President proposed one such plan in his State of the Union address; dozens of legislators, economists and study panels have offered other plans.

The President proposed crediting general revenues to the Social Security Trust Fund to enable Social Security to continue paying benefits for an additional 20 years, even though cash flow still would turn negative in 2013. This complicated proposal would dedicate 62 percent, or $2.8 trillion of anticipated unified budget surpluses over the next 15 years to the Social Security Trust Funds, in addition to the approximately $2.7 trillion in surpluses the Trust Funds are expected to accrue under current law.

President Clinton also proposed gaining additional income from investing 20 percent of the transferred $2.8 trillion in financial markets. Over time, investment of Trust Fund assets in common stocks will almost certainly yield more income for the Social Security program than investments in Treasury securities. The Administration is counting on the higher yields from private sector investment to achieve an additional six years of trust fund solvency.

Finally, the President proposes using about 12 percent of the anticipated surpluses, or $536 billion over 15 years, to finance Universal Savings Accounts in which individuals would receive a flat contribution from the government with additional matching government contributions based on an unspecified progressive formula.

Nothing in the President's plan would make the Social Security program less costly in the future

than it would be under present law. In other words, it doesn't change Social Security's bottom line: under current law, the Trustees project that Social Security and Medicare by 2040 will cost nearly twice what they do today as a percentage of workers' payroll. In fact, the President proposes two expansions of current Social Security benefits and an expansion of the Medicare program to include prescription drug benefits. In contrast, many of the plans proposed by Members of Congress and other groups spell out specifically what choices their sponsors would make in order to scale back the future growth in Social Security benefits. The President alludes to the need to do this in order to make Social Security sustainable indefinitely but declines to outline specific options.

It appears that the President proposes to transfer specified amounts of general revenues to Social Security whether or not the anticipated budget surpluses actually materialize. Although nothing currently on the horizon suggests that the surpluses will not be as large as expected, budget "surprises" frequently occur. The current business expansion is now in record territory, having run 96 months, longer than any previous expansion. Even an average size recession could erase or substantially reduce the projected surpluses. The Congressional Budget Office has sketched several alternative, plausible, scenarios outlining ways that domestic and international factors could lead to recession.

The President's proposal has been described as reducing the publicly held debt. The Concord Coalition favors reducing the publicly held debt. Debt reduction would free capital for investment in making the economy more productive in the future and, in addition to raising future standards of living, would enable tomorrow's taxpayers to better afford the burden of a large elderly population. However, although the President's proposal would reduce the publicly held debt below the level where it stands today, it would *raise* the debt compared to where it would stand under current law. In 2004, for example, if budget surpluses were permitted to stand, rather than being claimed for spending increases or tax cuts, the debt would decline from $3.67 trillion at the end of this year to $2.93 trillion at the end of 2004. Under the President's proposal, the publicly held debt would decline to only $3.3 trillion. Thus the President's proposal leaves the publicly held debt some $362 billion higher after five years than under current law.

Essentially, the President's confusing general revenue swap is an effort to make budget surpluses disappear so they aren't claimed for other competing purposes in the form of spending increases or tax cuts. Recent events confirm that nothing has changed, even under divided two-party government, with regard to the willingness of Congress and the White House to join together to use budget surpluses rather than reduce the debt. Earmarking the surplus for Social Security is an attempt to prevent a repeat of last year's end game "emergency" spending glut and use surplus dollars for long term saving rather than immediate consumption.

A decade's experience with off-budget Social Security balances amply proved that merely moving Trust Fund surpluses *off-budget* does not prevent them from being used to finance sizeable on-budget deficits. An alternative way to deploy the coming surpluses would be to move them *out of the budget*. This could be accomplished by transferring ownership by using the surpluses to fund individual retirement savings accounts.

The President's proposal to establish individual retirement savings accounts to augment the traditional Social Security program is a variation of this idea. Whereas most proposals for retirement

savings accounts would incorporate the accounts into the Social Security program, the President proposes keeping the accounts entirely separate. Unlike many individual account proposals, the President would not fund the accounts through FICA taxes, nor would they be geared to a specified percentage of workers' earnings.

An alternative to the President's individual account proposal would be to earmark a specified percentage of the unified budget surplus (or the entire Social Security surplus if smaller) for direct transfer into individual workers' retirement savings accounts. Like the President's proposal, this plan would reserve the surpluses for long-term savings rather than letting them be consumed for various short-term purposes. In effect, each worker would receive a tax credit in the form of a retirement savings account deposit. The money could not be withdrawn for any purpose other than retirement or death.

Using surplus funds to finance individually owned retirement accounts would do nothing to address the long-term unfunded liabilities of the Social Security program. Ideally, those difficult choices would be made in the same legislation that established the individual accounts. Even if the Congress and the White House were unable to agree on ways to hold down the growth in future benefits, using surpluses to finance individual accounts nevertheless would be a good step to take. After several years, as people began to amass a sizeable stake in their individual retirement accounts, the politics of bringing the traditional program into balance would become more favorable. It might even become possible to divert some money now going to retirement income into Medicare to finance retirement health insurance.

Using surplus funds to finance individual accounts does raise some concerns. One is that care must be taken not to do this in a way that establishes a new stream of entitlements that may not be affordable or sustainable in the future. On-budget surpluses still have not actually materialized, and if and when they do, they may not continue indefinitely. A recession of the severity of the 1991-1992 recession would turn projected surpluses into deficits for several years, for example.

One approach to avoid the "new entitlement" problem would be to devote a *percentage* of any budget surplus to the individual accounts rather than a dollar amount or a percentage of payroll. This would have the advantage of making the amount going into individual accounts each year contingent on the size of the surplus, if any, in the previous year. It could also create a pressure in favor of maintaining budget surpluses so that individuals would receive an annual infusion of new funds into their accounts.

Administratively, the most efficient means of making deposits into individual accounts would be to have the Treasury do this directly. In effect, a "tax credit" would be transferred into each worker's account and invested as designated, with a default option used for workers who failed to make any designation. Employers would not have to be involved in collecting, transmitting or accounting for the deposits, nor would they have any responsibility for the designation of investment choices. Administrative costs could be held to minimal levels by permitting Treasury to combine individuals' deposits into large transfers to designated private sector investment funds.

A straightforward, transparent and progressive way to determine how much each worker's account would receive would be to simply divide the portion of the budget surplus set aside for these accounts by the number of workers with at least, say, 1,000 hours of work in the preceding year. Thus every

member of the work force would receive the same dollar amount deposited into his or her retirement account. In years when the budget surplus became smaller, so would the universal retirement tax credit. Conversely, if surpluses grew, so would the credits. If as expected, the Social Security surplus was $134 billion in 2001, and if 130 million workers qualified for the credit, everyone's accounts would receive slightly more than $1,000. If, on the other hand, half the expected surplus had been used for other spending or tax changes, everyone's accounts would receive only $500.

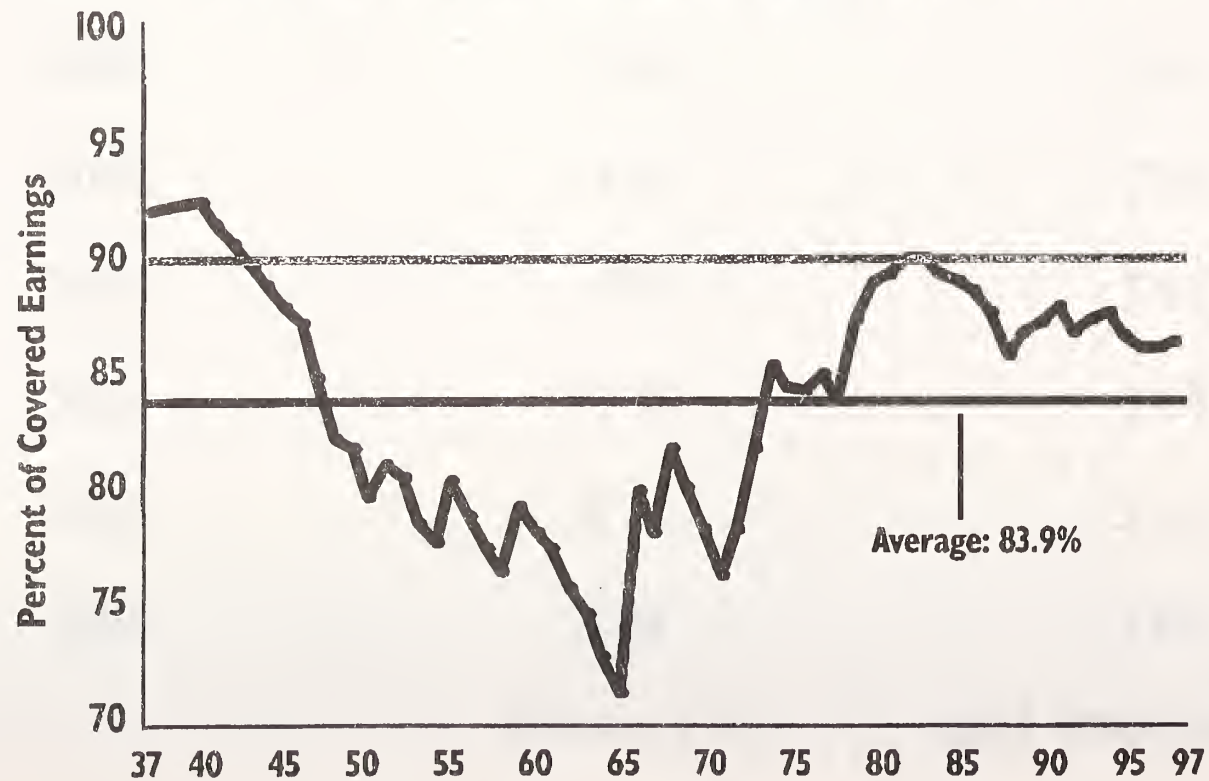
One reason that many are beginning to focus on using budget surpluses to finance individual retirement accounts is the difficulty of finding alternative funding sources. Most of the plans proposed thus far either carve out some of the current 12.4 percent payroll tax to finance the accounts, or they add on an incremental payroll tax. Both of these approaches raise problems. The more payroll tax that is carved out, the greater the reductions in future benefit growth must be. And adding on more payroll tax amounts to a tax increase. Theorists can explain why this additional saving is good for the economy as well as for individuals. They can also explain that because the proceeds for this mandatory "contribution" would belong to workers, along with the income generated from compounding investments, the mandatory contributions are really quite different from a tax increase. But since the contributions would in most cases reduce current consumption, most people would decide the add-on contribution was a tax, not matter what it was called. Using budget surpluses to fund retirement accounts offers a way out of this dilemma. However, the surpluses are temporary, and will disappear when the boomers retire and when Social Security costs being escalating dramatically. Therefore, diverting surpluses into retirement accounts can be only a beginning step, not a complete solution to the long term problem.

Annual OASDI Operating Balance as Percentage of Payroll

	Current Law	With Additional 2.2%
2000	1.48	3.68
2010	0.54	2.74
2020	-2.26	-0.06
2030	-4.66	-2.46
2040	-4.95	-2.75
2050	-5.07	-2.87
2060	-5.75	-3.55
2070	-6.20	-4.00

Source: The Concord Coalition

Social Security Taxable Earnings as a Percent of Covered Earnings, 1937-1998



Source: The Concord Coalition

The CHAIRMAN. Thanks to each of you. Very thorough testimony. I will start with Dr. Penner. You seem to be comfortable with your Social Security reform proposal which would rely on no general revenue transfers and very little on new revenue.

What assurance do you have that your approach will enable Social Security to provide the basic needs of the elderly as you look beyond 2032?

Dr. PENNER. I assume, Mr. Chairman, you are talking about the National Commission on Retirement Policy that I was associated with——

The CHAIRMAN. Yes.

Dr. PENNER [continuing]. And that Senator Breaux co-chaired. The intent of that plan is to reduce the payroll tax by 2 percentage points and put the difference into individual accounts. It also reduces the growth in benefits for the more affluent Social Security recipients while providing a new benefit that would create a minimum equal to the poverty line for low-income people.

You might characterize the plan as using some of the surplus now or worsening the current fiscal condition in order to get a big improvement in the long run, as the phased-in benefit reductions really bite.

But it does leave a recognizable Social Security system in place. Very roughly speaking, the return on the individual accounts basically makes up for the reduction in benefits for most people, but if they do very badly in the individual accounts, as I said, the worst off get this guarantee of a poverty line benefit.

For most people, they would still have a substantial Social Security system to fall back on.

The CHAIRMAN. Dr. Rasell, the President's proposal ties debt repayment to Social Security by basically increasing the number of IOU's in the Social Security trust fund. You endorsed this approach, but stated that devoting 62 percent to Social Security is too much. Are you saying the President went too far by putting another 20 years worth of IOU's in the Social Security trust fund?

Dr. RASELL. When you say go too far, I guess I am referring to the total amount of money that he is suggesting go into the Social Security trust fund from the 15-year surplus. I think given the other needs, especially Medicare, that we cannot afford to put that much of the surplus, to commit to that much over a 15-year period given that we have got these other things that need to be addressed as well.

The CHAIRMAN. So it is a tradeoff for you. You are not saying that Social Security does not need it or that it would not be good to put it there?

Dr. RASELL. Right. Social Security does need more money than what I have suggested it would get from the surplus, but I do think there are other things that we can do to get money for Social Security.

I think that because people are living longer, they are going to have to pay more in taxes to pay for their retirement. I think we should also raise the cap. People at the higher income levels ought to be contributing more and not just see that continuing erosion because their wages are growing faster and they are exceeding the cap on income subject to the tax.

So I think we have got other options for getting money into Social Security and we can use some of the surplus money and then use the rest in other places.

The CHAIRMAN. Ms. Phillips, you suggested that the way to ensure workers get some long-term savings from the protected surpluses is to transfer any surpluses to individual accounts. If we go that route, we lose some of the ability to pay down the debt.

Is there no other way, from your point of view or your coalition's point of view, to prevent future presidents and future Congresses from spending this money instead of using the surpluses to repay debt?

Ms. PHILLIPS. We have been working very long and hard to try to get the surpluses saved for Social Security, to make sure the off-budget Social Security money was reserved for that purpose, and it is very, very hard. Frankly, last October was a very disheartening reminder of how difficult it is when there is this illusion that there are large budget surpluses just available, $4.5 trillion we now hear. In that kind of climate, it is just awfully hard to get people to say "No, it is not the right thing to do, we will not spend it.

Transferring the ownership of this money to the individuals whose retirement and whose health insurance benefits we are trying to secure would give them ownership of this money now in a way where they cannot touch it. It could only be used for their retirement or for their estates or perhaps force them to will it to their children for their retirement. At least that is a way to make sure that the money is used for its intended purpose.

It does not increase the debt to do that, but it does stop you from whittling away Social Security money for current purposes that are very nice, but do not help you over the long run.

The CHAIRMAN. Dr. Primus, you probably were here when I was discussing with Secretary Summers about how realistic these surpluses are and you raised some question about that. So I think the administration ought to thank you for providing them a rational argument in supporting the transferring of general revenue to Social Security and Medicare.

You indicated that we need to be careful about policies which rely upon projected surpluses rather than actual surpluses. How much of these surpluses do you think are likely to materialize? Let me put it another way.

I have always referred to rosy scenarios that we projected, maybe not as rosy now as they used to be, but still, do you feel that these surpluses for the next 15 year are too rosy?

Mr. PRIMUS. I think that it is an important question and I guess I think I have no basis for arguing that they are too rosy or too conservative. I mean, both CBO and OMB are——

The CHAIRMAN. But I am right? You were arguing that we need to be very cautious?

Mr. PRIMUS. Yes. I guess if the purpose of the transfer is to basically give you the incentive to do public debt reduction, why don't we transfer the actual amount of public debt reduction that you do as opposed to an estimate of how much you are going to do over the next 15 years?

I mean, the basis for the transfer is the estimate, not the actual amount, and I understand from the actuaries that they have dif-

ficulty then giving an actuarial projection if they change their proposal from estimated to actual.

Therefore, I was suggesting an alternative basis that could be estimated that I think is very rational and that is, if you do not remove the restriction on where Social Security can invest its monies, then the Social Security trust funds ought to get the benefit of that loss of income from that restriction.

So yes, I do have difficulty with transferring estimates. I have less difficulty with transferring actual amounts of public debt reduction achieved and I absolutely have no difficulty if you actually save some on-budget surpluses. I think those definitely should be transferred, could be transferred to Social Security and Medicare because they really represent the fact that you are not giving a tax cut or not spending it on some other public program.

The CHAIRMAN. Senator Lincoln.

Senator LINCOLN. Great thoughts after last week's bill on the floor. Is it Dr. Rasell?

Dr. RASELL. Rasell.

Senator LINCOLN. Rasell. You said that you would increase the FICA tax rate of two-tenths, is that correct?

Dr. RASELL. Two-one hundredths.

Senator LINCOLN. Oh, .02?

Dr. RASELL. Yes.

Senator LINCOLN. Of the percentage point each year as a way to index the tax rate to increased longevity. Do you think this would place an undue hardship on the lower income workers and the single mothers?

Dr. RASELL. Well, I think any tax increase, you know, is an increased burden. However, as I mentioned, wages are going to be rising about 1 percent a year, according to what the trustees project, so this is far smaller than that.

I think the goal of economic policy should be to make sure that those wage increases are actually received by low-income workers. I mean, I am sure you know that over the past 20 years, most of the wage increases have been at the top. In fact, wages were falling for many people in the bottom end of the distribution.

In that situation, just maintaining taxes is a growing burden. So I think if we can do policies that make sure that wages rise for the majority of the workers, including those at the bottom, then they are going to have more money and they are going to have a rising standard of living even if their tax rate is going up.

Senator LINCOLN. But that is very dependent on the assurance that you said earlier, that we are increasing those wages. I do not know. I see it more as Ms. Phillips described a flat tax. Those are very difficult on certainly the lower income, the elderly who are on fixed incomes, single working mothers, which I think would be very, very difficult and very devastating to some.

I am curious, Ms. Phillips. How do you think that the baby boomers would react to your proposal of making Social Security benefits fully subject to the individual income tax?

Ms. PHILLIPS. Well, I think the people who are younger and who are paying payroll tax now would prefer that to a payroll tax increase. Once they are retired, everybody sort of looks at his or her

neighbor and tries to compare circumstances, and you can always find an invidious comparison.

You can always find someone to compare yourself to and say I am not getting along as well, but I think when you look at the tax treatment of seniors at a certain income level versus people with the same income level and greater family responsibilities who are younger, the comparison just breaks down.

I think that there would be some equity in increasing the taxes on benefits, subject to our progressive income tax system. The people at the bottom of the income destruction get the extra exemptions, they have their deductions. They will be protected just as much as a 20, 30, 40, or 50-year-old couple with the same income would be protected.

Seniors, yes, they may have more expense for medical care, but working age people have day care expenses and commutation expenses and on and on. So everybody has got problems and nobody has ever got enough income. Nobody is going to like more taxes.

Can we solve the entire problem on the benefits side? Can we solve the entire problem through investment in the markets? Probably not. We are leaving the realm of these sleek, sculptured, elegant models and now we are edging closer to a bargaining table. It is probably going to be a pretty messy bill when it is all done. And it is going to include, most likely, some revenue increases, some benefits reductions, and some private market savings. Who knows right now what the mix will be, but people who have their taxes increased are not going to like it.

Senator LINCOLN. Well, you may remember my terminology from my opening statement, which was lively conversation in these areas, and we are certainly looking forward to it. Thank you, Mr. Chairman.

Mr. PRIMUS. Senator, may I respond to one comment that you made?

Senator LINCOLN. Sure.

Mr. PRIMUS. That is, I actually think you are a little too hard on yourself in the sense of, you have come a long ways from $300 billion deficits now to $300 billion surpluses. I mean, I think Congress has shown a lot of budget discipline.

The other argument that is being made about individual accounts is that the Government cannot really say what almost all of the State legislatures say. If they did the accounting the same basis as we do accounting here and you included the State pension funds in the State budgets, the State budgets would be in surplus.

So I think this Congress does and can exercise a discipline to set aside the Social Security surplus and keep it from being spent, et cetera. The other thing you have to remember——

Senator LINCOLN. I do not think that discipline was exhibited last week in terms of what we were presented with.

Mr. PRIMUS. No, I realize that. That is a good counter-example, but discretionary spending is also at an all-time—not an all-time low, but it has not been that low for the last 20 or 30 years and there is some pent-up demand for spending.

Senator LINCOLN. Well, we are hitting the three most difficult years. I mean, I came in 1993—elected in 1992—we are hitting the three most difficult years right now and that is why you are seeing

obviously the difficult decisions that need to be made. I do not know.

I was very disappointed in what we did on the floor last week and I hope that we can show some more fiscal restraint in terms of trying to meet the goals that we set for ourselves in 1993 in balancing the budget, which we have done, but still eliminating the debt as well. It is not going to be easy.

The CHAIRMAN. Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman. Dr. Primus, I was Governor of our State for 8 years and governed during recessions and governed during better times. Even at the State level, it never seems that there is enough to go around. It is just a part of human nature, I think.

Ms. Phillips, if I could ask you a question? I did not really understand your proposal for transferring some of the projected surplus into individual accounts and how would that—you are suggesting that would indirectly strengthen Social Security by accomplishing some of the same objectives through a different vehicle?

Ms. PHILLIPS. Social Security is supposed to assure retirement income security. Medicare is retirement health insurance security. We are very concerned that any of these proposals, such as the Feldstein proposal or others, might create a new entitlement.

On the other hand, if you set up a contingent plan that said, if there is a surplus, we will transfer X percent of it to individual accounts. That will be their tax cut. Concord would go even further.

We are kind of intrigued with the idea that everybody who has worked more than, say, 1,000 hours last year there has to be some attachment to the work force—but every person who has worked more than 1,000 hours, should get the same dollar amount. Just divide it up equally and everybody gets the same dollar amount.

The Treasury transfers it into your account. The employers are not part of this deal at all. They do not have to take it out of your paycheck or do any calculations or know what your investment preference is.

Senator BAYH. You do this in lieu of debt reduction?

Ms. PHILLIPS. On-budget surpluses probably would still reduce the debt or keep the debt from growing. We would look at using Social Security surpluses or some percentage of it.

We principally favor this in lieu of tax cuts and spending increases, and if you cannot work out an overall deal that involves responsible revenue and benefit choices for the long run, if that breaks down and you are stuck with a default option, we think it makes a lot of sense to consider parking some of this surplus in the ownership of the individuals whose retirement you are trying to assure.

Maybe you come back the following year or the following election and deal with shoring up the Social Security system.

Senator BAYH. Sort of a one-time or temporary transfer. At some point, we will not have these surpluses and what do you do for folks then?

Ms. PHILLIPS. That is again why we are so concerned. We do not want to create a permanent entitlement because we do not think—first of all, there is no——

Senator BAYH. I am just curious about the equities of transferring the money to individuals for a certain period of time, but then what about the next generation coming along that will not get the transfers and has to rely on Social Security that had not really been?

Ms. PHILLIPS. Well, I think that will create some pressure on you to reform Social Security, but we are very concerned that the surpluses will not last. We are also concerned that they might not even materialize the way things are going.

If they do not last, then you surely do not want to create an entitlement that transfers a certain amount of money to everybody based on some percentage of payroll if you do not know that that money is going to be there.

If everybody in the country were getting the same dollar amount into their retirement savings account, and this was contingent of the size of the surplus, I think you all would be under a lot of pressure to make sure there was some surplus because if you cut taxes or spent the money, people would not be getting $1,000 next year, they would only be getting $750 or $290 or whatever, so people would be watching this number.

Senator BAYH. Thank you very much. We had at least two of our panelists who were opposed to equity investments. Is that how I understood that? I am curious. One of you must know and I should have it off the top of my head and I do not, the current rate of return we are getting off the Social Security fund, 2 point something?

Dr. RASELL. No. It is actually, right now, about 6.5 because some of the bonds are quite old.

Dr. PRIMUS. That is the nominal rate. Two point eight is the real rate.

Dr. RASELL. Well, OK.

Dr. PRIMUS. There is a difference.

Senator BAYH. Two point eight is the real rate?

Dr. PRIMUS. Right, after inflation.

Senator BAYH. After inflation? OK, I understand. Well, it just seems to me, and again we are about running out of time and I appreciate all of your patience today and I have been impressed by your presentations.

Many of these choices, as you know very well, are going to be so difficult. It is just going to be very difficult to accomplish virtually any of these measures; that trying to ease the burden somewhat through generating higher rates of return in some acceptable way has to be included in the mix.

That is not in the spirit of trying to avoid hard choices. It is just sort of putting on my realist's hat and saying there is only so much you can expect a democracy to do to itself.

Dr. PENNER. And I think the risks of that are very high, Senator.

Senator BAYH. The risk of which, Doctor?

Dr. PENNER. Of having the Government invest in that much equity. I just think it is a tool out there, and it will be very hard to resist using that for social purposes rather than for any common purpose.

Senator BAYH. Then let me put the question to you directly then. It is a balance of risks here. I share your concern, I do, and I have listened intently to Secretary Summers and others describe the

mechanisms, the hoops that they have tried to erect to prevent that sort of thing from happening.

I am also a little skeptical about human nature in that regard, too, so I share your concern. But is that risk counter-balanced against the risk of not really making the Social Security system actuarially sound because we will not have the wherewithal, the intestinal fortitude to make some of these choices absent some increased return on our funds.

So how do you balance that off, the risk of social investing, so-called, versus foregoing the opportunity to generate a higher rate of return, therefore not making it actuarially sound?

Dr. PENNER. I think, Senator, there has been much too much discussion of the accounting of the trust fund, which is really totally unimportant in this whole issue. The burden on the Government is paying the benefits. That is what we have to raise money for. The amount in the trust fund has nothing to do with that. The burden will manifest itself when there is an excess of benefits over payroll taxes and at that point, we will have to sell securities to the public or raise taxes or reduce benefits, or, in the worst of all cases, create new money, which would be a disaster.

We just cannot avoid that and it really does not make that much difference economically whether you are selling bonds to the public at that point or stocks. We still have to do it. Getting a higher rate of return on what is in the trust fund in no way affects the benefits that we have promised. So it may have big political importance, but I think the political incentives of having more in the trust fund are all bad.

Senator BAYH. Does it not postpone the day of reckoning if you generate a higher rate of return?

Dr. PENNER. That is exactly the problem I think that there has been some discipline in the system because of the presumption that the bulk of benefits would be financed by the payroll tax.

The President's program destroys that presumption by just throwing a bunch of assets in the trust fund, investing in equity, also, and theoretically as you say, put off, postponing dealing with this real economic burden, which is paying the benefits.

Dr. RASELL. If I could——

The CHAIRMAN. Well, I will get to you. Dr. Primus eyed me first and then Dr. Rasell.

Dr. PRIMUS. I also want to point out that there is political risk to individual accounts. It may be a different political risk, but imagine if the accounts had been set up for 10 years and then we get to the situation you are confronting, to some extent, in Iowa with the agricultural market depressed.

Could you resist opening up those individual accounts, saying for a limited period of time, those farmers should be able to use those accounts? Or what about using the account to buy a home or college education? I mean, the question is, if you set up an account and say this is Individual X's account, can you politically say it is only going to be used for retirement and you cannot get to it until 62?

Or another kind of risk is, I think if they are going to protect against longevity, a widow living to age 95, then you also have to force annuitization and the question is, you know a number of your

constituents will have cancer, will be in a hospice, you may be in bad economic times.

Will you say, yes, I know that, but for the good of the system, we have got to force annuitization. We know you will only get benefits for a very short period of time.

My point is, there is political risk in both ways and you have to weigh Dr. Penner's arguments about political risk of collective investment versus the political risks that are associated with individual accounts.

The CHAIRMAN. We obviously gave that flexibility to the IRAs already. Dr. Rasell.

Dr. RASELL. The point I wanted to make was that it really does not make a lot of difference whether we put money in the stock market or not. Senator Hutchinson earlier asked a question of Secretary Summers, I think based on possibly something I had written in my testimony about the rate of return and how it is commonly thought that in the future, the average rate of return will be about 7 percent, which is what it has been in the past.

I hope that you all will pursue this issue because——

Senator BAYH. That is a nominal rate?

Dr. RASELL. This is real, this is real.

Senator BAYH. Seven percent real rate of return?

Dr. RASELL. That is correct, in the past in the stock market. Because I think it is very important. The question is, if the economy slows down, which we are all presuming is the case—I mean, this is what the trustees project and this is what we are arguing about anyway—if it does slow down, you know, you have—the price rises as the fundamentals, in most cases, apart from the last couple years.

But if we are not in an episode of a speculative whatever, it depends on the fundamentals, which is primarily profits and profits, from year to year, could go wherever they want to go, but in the long term, profits follow economic growth.

They do not grow faster than the economy grows. I do not care whether it is because the population is growing fast or slow or productivity is fast or slow, economic growth determines profit growth. If profit growth slows down, the rate of return on stocks will also slow down.

If it flows as you can mathematically show down to 4 percent—the difference between 4 percent real and 2.8 percent real is what the trustees project to be the return on bonds—that is not such a big difference and you are only talking, as Secretary Summers said, 15 percent of 28 percent of the money in the fund.

The differences are going to be small whether or not we do it. I would argue that the risks would outweigh those potential small benefits in the increased return.

The CHAIRMAN. Well, I thank all my colleagues for being present. We had half of the committee present and I appreciate that very much. I feel like this panel could go on all afternoon, just like I felt Secretary Summers' presence here, that we could have had a discussion for two or three rounds.

This is just one step in many steps of this committee and other committees to help move along the issue of making sure that the very important issue of Social Security, which is a very important

part of the social fabric of our society, is continued for baby boomers and beyond.

After two panels now, I feel that it is not so much the substance of the issue as it is the process. What do we do to get the process where people from the administration are sitting down with those of us from the Congress to actually start moving things along.

I hope that this discussion will help us along that line. So once again, thank you to an outstanding panel we had and for your contribution to this issue and thanks to my colleagues. The meeting is adjourned.

[Whereupon, at 3:45 p.m., the committee was adjourned.]

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